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T. C. Memo. 1986-352

UNITED STATES TAX COURT

JAMES E. MCFARLAND, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 17969-85. Filed August 6, 1986.

James E. McFarland, pro se.

Christine V. Olsen, for the respondent.

MEMORANDUM OPINION

PATE, Special Trial Judge: This case[1] was heard pursuant to the provisions of section 7456(d)(3)[2] and Rules 180, 181 and

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1 This case was originally filed as a small tax case pursuant to section 7463. By order dated May 13, 1986, the Court granted petitioner's motion to remove this case from the small tax case category.

2 Unless otherwise specified, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

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182.[3]

Respondent determined deficiencies in petitioner's Federal income tax as follows:

	1981	1982
Income Tax	$11,889.00	$2,812.00
Additions to Tax		
6651(a)(1)	2,952.10	703.00
6653(a)(1)	594.45	140.00
6653(a)(2)	50% of interest due on $11,889.00	50% of interest due on $2,812.00

The issues for our decision are (1) whether petitioner is liable for income taxes on the income reflected in the notice of deficiency, (2) whether petitioner is liable for additions to tax under section 6651(a) and section 6653(a), and (3) whether we should award damages under section 6673.

Petitioner, James E. McFarland resided in Newberg, Oregon at the time his petition was filed. Respondent determined that during 1981 and 1982 petitioner should have reported income from the following sources in the amounts listed below.

YEAR	SOURCE	AMOUNT
1981	Allegheny Industries	$ 1,672.00
	Lord Electric Co.	12,199.00
	Rosendin Electric	4,213.00
	Electrical Constr.	14,224.00
	National Industries, Inc.	10.40
	State of Oregon Unemployment	2,760.00
	Total	$35,078.40

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[3] All Rule references are to the Tax Court Rules of Practice and Procedure.

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YEAR	SOURCE	AMOUNT
1982	James Electric, Inc.	$ 372.00
	McCoy Electric Co.	915.00
	Sunset Electric Co.	934.00
	Sutherland Electric Co.	6,635.00
	Bohm Electric, Inc.	821.00
	Jagger Stroufe Co.	821.00
	National Industries, Inc.	23.00
	State of Oregon Unemployment	5,016.00
	Total	$16,037.00

With one exception,[4] petitioner does not dispute that he received income from the above listed sources during the years in issue. However, petitioner asserts that he was not required to file an income tax return or pay any tax because he neither had a "contract" with the Internal Revenue Service requiring him to pay such tax, nor does he come within the meaning of "taxpayer" for purposes of Title 26 of the U. S. Code. In addition, petitioner contends that this Court does not have jurisdiction to hear his case.[5]

Petitioner bases his allegations upon long-rejected arguments frequently put forward by tax protestors. There is no doubt that petitioner was required to file valid income tax

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At trial, petitioner indicated that the name "National Industries" was unfamiliar to him and he did not remember receiving any income from that source. However, he failed to present any evidence that he did not receive such income.

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Petitioner made several other allegations in his petition and amended petition which he never subsequently addressed. Therefore, these allegations are deemed abandoned. See Stemkowski v. Commissioner, 76 T.C. 252, 312 (1981), affd. in part, revd. and remanded on other grounds 690 F.2d 40 (2d Cir. 1982); Theodore v. Commissioner, 38 T.C. 1011, 1041 (1962).

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returns for 1981 and 1982 and that he was required to pay taxes on his wages and other income. See secs. 1, 61, 6011, 6012(a)(1)(A), 7701(a)(1); sec. 1.6012-1, Income Tax Regs.; Rowlee v. Commissioner, 80 T.C. 1111 (1983) and the cases cited therein.

Furthermore, after respondent issued a valid notice of deficiency, petitioner filed a timely petition with this Court. Consequently, this Court has jurisdiction over this case. Secs. 6212, 6213 and 6214; see Pyo v. Commissioner, 83 T. C. 626, 632 (1984). The United States Tax Court is a Court of record under Article I of the Constitution, and it is duly empowered to hear cases such as this. Secs. 7441 and 7442; Burns, Stix Friedman & Co. v. Commissioner, 57 T.C. 392 (1971).

Respondent's determination of the income tax deficiencies is presumptively correct. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933). Petitioner admitted that he received income from all but one of the sources shown in the notice of deficiency and has offered no evidence to show that any of the amounts contained therein are incorrect. Accordingly, we sustain respondent's determination.

Respondent also determined that petitioner was liable for additions to tax under section 6651(a)(1) for failure to file income tax returns. Petitioner admittedly filed no returns for the years 1981 and 1982 although the amount of income he received required him to do so. See sec. 6012; sec. 1.6012-1, Income Tax Regs. Further, petitioner presented no evidence

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excusing himself from those requirements. Accordingly, we find that he is liable for the additions to tax under section 6651(a); Thompson v. Commissioner, 78 T.C. 558, 562-563 (1982).

Respondent also determined that petitioner was liable under section 6653(a) for additions to tax for negligence and intentional disregard of the rules and regulations. This determination will be upheld unless petitioner shows that the underpayments of tax were not due to negligence or intentional disregard of the rules and regulations. McGahen v. Commissioner, 76 T.C. 468, 484 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983). Again, petitioner's sole argument is that he was not subject to the tax imposed by Title 26. Consequently, we find for respondent on this issue.

Finally, we must decide whether to award damages to the United States under section 6673. This Court may award damages of up to $5,000 whenever the taxpayer institutes or maintains proceedings before us primarily for delay or the taxpayer asserts a frivolous or groundless position in such proceedings. We find that petitioner's contentions, in light of the cases cited above (and numerous others considering these same arguments), are frivolous and groundless. We are satisfied that petitioner has instituted this proceeding primarily for delay. Abrams v.

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Commissioner, 82 T.C. 403 (1984); Sydnes v. Commissioner, 74 T.C. 864, 870-873 (1980), affd. 647 F.2d 813 (8th Cir. 1981). Accordingly, we award $5,000 of damages to the United States.

Decision will be entered for the respondent.

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T. C. Memo. 1986-353

UNITED STATES TAX COURT

EDWARD H. BOSEKER and YVONNE J. BOSEKER, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 27643-82. Filed August 6, 1986.

Howard M. Larsen, for the petitioners.

Patrick E. McGinnis, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: Respondent determined the following deficiencies in petitioners' Federal income taxes:

Year	Deficiency
1978	$83,025
1979	7,993
1980	7,197

After concessions, the issues for decision are whether petitioners are subject to the limitations on investment interest deductions contained in section 163(d)[1] and whether petitioners are entitled to casualty loss deductions in 1978 and 1980 in excess of the amounts allowed by respondent in his notice of deficiency.

FINDINGS OF FACT

Some of the facts have been stipulated. The facts set forth in the stipulation are incorporated in our findings by this reference.

Petitioners Edward H. Boseker (petitioner) and Yvonne J. Boseker resided in Santa Ana, California, at the time their petition was filed. They filed joint Federal income tax returns in 1978, 1979, and 1980 with the Internal Revenue Service Center

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

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in Fresno, California. During the years in issue, petitioner was employed as a physician by Edward H. Boseker M.D., Inc.

In or about June 1977, petitioner purchased the Erle Stanley Gardner Ranch (the Ranch), a land parcel of approximately 585 acres located in Riverside County, California, from an unrelated partnership (the "Burns Partnership") managed by Harry Burns (Burns). In January 1978, petitioner expanded the Ranch by purchasing an adjoining parcel of approximately 80 acres.

As of August 20, 1985, the Ranch included approximately 650 acres. The upland area of approximately 312 acres included foothills and hilly slopes of steeply rising sierra, portions of which are classed as rockland. Because of steep slopes, shallow depth to bedrock, lack of water, and rock float, the upland soils were considered, as of August 20, 1985, adaptable only to wildlife. Approximately 220 acres comprised the valley and valley terrace areas and were utilized for farming purposes. The soil in this area was regarded as good agricultural (and urban) soil. Farmstead areas occupied approximately 33 acres, and the Pechanga Creek bottom occupied approximately 18 acres. The Pechanga Creek was designated as riverwash, subject primarily to seasonal storm flows, and the Ranch was within the floodplain of the Pechanga Creek, i.e., the area into which the creek may overflow during flooding.

The Ranch is accessible by county roads at several points. It borders an Indian Reservation and is located in an area with lengthy agricultural uses which, in the two decades preceding

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1985, began to be replaced with suburban rural homesite uses. For instance, near the Ranch is Rancho California, a large development of numerous land divisions oriented to mixed uses including agricultural, single family and multiple family residential, offices, commercial, and some industrial and manufacturing uses. At all relevant times, the Ranch was zoned "R-R" or Rural Residential, which permits all light agricultural uses including animal husbandry (maximum 5 animals per acre) and single family residential uses.

The Burns Partnership purchased the Erle Stanley Gardner Ranch in or about 1975. Erle Stanley Gardner had used the Ranch primarily as a retreat and workshop for his writing. The Burns Partnership, however, intended to grow grapes for wine production on approximately 300 acres of the upper and lower flat areas of the Ranch. After extensive research, the Burns Partnership cleared approximately 80 acres in the upper levels, installed roads for access to the upper levels, installed a well and tanks for water, and purchased metal pipes and wire for the vines. Before any grapevines were planted, the wine market incurred a dramatic change, and the project became too risky for the Burns Partnership. The Burns Partnership began farming the property; hay was planted and a few cows and pigs were purchased.

Subsequently, the Burns Partnership commenced a process of subdividing the property with the intent of selling "small farms" or "ranchettes." A parcel map was prepared, and surveying and other engineering work were commenced. During this period, the

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Burns Partnership sold the Ranch to petitioner for $1,600,000, including certain payments of cash and an installment note for $1,400,000. As part of the consideration, petitioner paid $25,000 for some of the surveying and engineering projects begun by the Burns Partnership and completed or almost completed at the time of sale.

The parties executed an Amended Trust Agreement (Trust Agreement) that was drafted by a trust officer pursuant to instructions by Burns. The Burns Partnership paid for the preparation of the 36-page Trust Agreement, which was similar to other trust agreements prepared for Burns. The Trust Agreement designated Security Title Insurance Company as Trustee and holder of legal title to the Ranch. The Trust Agreement described its purpose as follows:

ARTICLE II - PURPOSE

> 1. It is the intention of FIRST BENEFICIARY [the Burns Partnership] and SECOND BENEFICIARY [petitioner] that this trust is created and established for the following general purposes:
>
> (a) To, from time to time, subdivide all or portions of the Trust Property.
>
> (b) To sell, lease or otherwise dispose of said property, it being presently contemplated that sales of subdivided portions of said property may be made to members of the general public * * *.
>
> * * *
>
> (d) To secure to the FIRST BENEFICIARY and the SECOND BENEFICIARY their respective

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> rights and interests, as hereinafter defined and set forth.

The Trust Agreement also numbered and described 20 subdivided parcels within the Ranch. If petitioner sold any portion of the Ranch property during the life of the trust, petitioner was required to pay the Burns Partnership the specified amount(s) corresponding to the particular parcel(s) sold. Although the Trust Agreement did not require or otherwise induce petitioner to sell any of the Ranch property and although Burns did not know what petitioner intended to do with the property, the purpose of these provisions was to protect the interests of the Burns Partnership.

Before the sale was closed, petitioner received a letter from Burns dated July 18, 1977, requesting his approval of certain projects and activities currently in process. Specifically, it directed petitioner to designate "yes" or "no" beside 22 items listed under the heading "Improvements & Work Planned by Present Owner"; petitioner would bear the expense of some of those items. Among the items in the list were a tennis court, a swimming pool, roads, farm equipment, vehicles, and trees to be planted. The letter also included the following paragraph:

> It was certainly nice meeting and talking to you on my recent trip and I know the resale will be a tremendous success and you will get much enjoyment from same as we have done over the past few years.

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Although petitioner left the list substantially unmarked, except tax bonds (yes), cultivation (no), pigs (yes), surveyor's bill (yes), and cash monument bond (yes), he did write and initial a notation at the bottom of the letter that he may purchase some of the vehicles and farm equipment.

Petitioner employed a ranch manager, Jeffery Loefke (Loefke), who had also managed the farm for the Burns Partnership. Loefke suggested to petitioner that an avocado orchard or a vineyard might be feasible, and that there was sufficient water in the upper levels for the development of an orchard. Petitioner planted a test site of citrus and avocado. Petitioner purchased substantial farm equipment and machinery, and he converted the tennis court into a hay barn. Approximately 220 acres of the property were devoted to hay farming, specifically oat hay and alfalfa hay, and approximately 40 acres were devoted to cattle grazing. Also, petitioner "cleaned up" and began to rent or lease a few homes located on the Ranch.

Petitioner looked to others for farm and ranch consultations, including William McMillan (McMillan), who was paid $27,454 in 1978 and 1979. Among other things, McMillan advised petitioner to raise replacement heifers, grow oat hay, and to plant 40 acres of kiwifruit and 40 acres of Macadamia nut trees.

Petitioner maintained certain records regarding the cattle operation on the Ranch in 1979, 1980, and subsequent years. The records included descriptions of the livestock, dates of

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purchase, dates of sale, and prices. Attached to the records are copies of checks to petitioner for cattle sales and copies of receipts for purchases and sales at cattle auctions. Petitioner maintained yearly summaries of production of oat hay and alfalfa hay commencing in 1980. Petitioner also maintained a separate bank account for the Ranch under the name "Boseker Great Oak Ranch."

Riverside County requires a seller of real estate to provide the purchaser with a "white paper," a document describing water availability, sewage, bus routes, electricity and other details a new owner of property would like to know. The white paper must be renewed periodically or it will expire. At about the time petitioner expanded the Ranch, he became concerned about his ability to make the large payments on the note; thus, petitioner had white papers prepared for 4 of the 20 parcels as a security measure in case he had to sell some of the Ranch property to make his payments. Petitioner, however, never sold or attempted to sell any of the parcels within the Ranch. Petitioner never renewed the white papers, and they subsequently expired.

Because of severe storms, mudslides, and flooding on or ending on February 5, 1978, and January 8, 1980, President Carter declared several counties in California, including Riverside County, National Disaster Areas on those respective dates. See Rev. Rul. 78-440, 1978-2 C.B. 115; and Rev. Rul. 80-357, 1980-2, C.B. 64. As a result of the flooding on the Ranch, roads were washed out, fences damaged, soil eroded, and debris accumulated.

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After examining the damage to the Ranch, a real estate broker sent a letter to petitioner on February 11, 1981, that included the following paragraph:

> I think that a satisfactory listing value of the property at this point in time would be 1.2 million dollars as I believe there is at least $400,000 in physical damage which must be repaired before the farm can be returned to a satisfactory working unit.

In a letter dated March 8, 1981, a farming and consulting agent, Robert McKinley (McKinley), referred to "near total destruction" to six parcels and extensive damages to four parcels, all of which were involved in farming. McKinley offered several suggestions for restoration and for preventive measures. Further, McKinley estimated that it would cost petitioner approximately $300,000 over 4 to 5 years to restore the land.

The following table describes the cost of restoration estimated by the Riverside-San Diego County Agricultural Stabilization and Conservation Service Office and the funds remitted to petitioner as part of a government sponsored cost-sharing program:

	1978	
Needed Practice	Estimated Cost of Restoration	Cost-Share Earned (Paid to Petitioner)
Debris Removal	$ 12,874	$ 6,429
Releveling	12,280	8,000
Restoring Fence	1,300	724
Restoring Structure (Dam Repair)	1,300	1,040
Total	$ 27,754	$16,193

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1980

Needed Practice	Estimated Cost of Restoration	Cost-Share Earned (Paid to Petitioner)
Debris Removal	$ 10,000	$ 2,460
Grading & Releveling	6,000	4,260
Fence Restoration	2,000	820
Restore Structure	6,000	2,460
Total	$ 24,000	$10,000

On every form describing the cost-share earned for each needed practice, petitioner affirmed that he would bear all the expenses (except for program cost-sharing) for performing the practice.

Petitioner expended a total of $8,691 to repair damages from the 1978 storm and $18,801.28 to repair damages from the 1980 storm.

On Schedules F, Farm Income and Expenses, petitioners reported, among other things, interest expense deductions of $118,684, $119,000, and $107,100 and net farm losses of $201,086, $194,413, and $185,328 in 1978, 1979, and 1980, respectively. On separate schedules, petitioners reported casualty losses resulting from the floods of $37,944 and $50,000 in 1978 and 1980, respectively.

In his notice of deficiency, respondent determined that with respect to the Ranch petitioners were subject to the limitations on investment interest and disallowed the interest expense deductions reported on Schedules F in 1978, 1979, and 1980 in excess of the amounts determined allowable. Respondent also

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disallowed a portion of the casualty losses claimed in 1978 and 1980.

By amendment to the petition, petitioners allege that the casualty loss in 1980 was $400,000.

The value of the Erle Stanley Gardner Ranch was $1,325,000 on June 23, 1977; $1,425,000 on June 31, 1980; and $1,592,000 on June 31, 1985.

OPINION

The first issue for determination is whether the Ranch is investment property such that petitioners' indebtedness thereon would be subject to the limitations on investment interest deductions contained in section 163(d). Petitioners contend that they did not hold the property for investment but rather to operate it as a farm, i.e., to engage in a trade or business activity. Thus, petitioners argue that section 163(d) does not apply to the interest expenses on the installment note for the Ranch. Petitioners have the burden of proof. Rule 142(a), Tax Court Rules of Practice and Procedure.

Section 163(a) generally allows "as a deduction all interest paid or accrued within the taxable year on indebtedness." Section 163(d), however, limits a deduction for interest incurred on investment indebtedness:

> (1) In general.--In the case of a taxpayer other than a corporation, the amount of investment interest * * * otherwise allowable as a deduction * * * shall be limited, in the following order, to--

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(A) $10,000 * * *, plus

(B) the amount of the net investment income * * *.

Section 163(d)(3)(D) defines "investment interest" as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." "Property held for investment," however, is not defined in section 163(d) or the regulations thereunder.

For determining whether property was held for investment, we have identified the applicable test as whether there was "substantial investment intent" in the acquisition or retention of the property. Miller v. Commissioner, 70 T.C. 448, 455 (1978). See also W. W. Windle Co. v. Commissioner, 65 T.C. 694 (1976). Although the issue in Miller arose under section 57, we noted that both sections 57 and 163(d) attempt to deal with the perceived abuse arising from the deductibility of interest paid on loans obtained to finance investments that will ultimately produce capital gains. Miller v. Commissioner, 70 T.C. at 454 and 455. See also H. Rept. No. 91-413 (1969), 1969-3 C.B. 200, 245. The test in Miller, however, was articulated in terms of stock, which is normally a capital asset owned for investment purposes. Miller v. Commissioner, 70 T.C. at 455. Although that test might be stricter than for property which is not normally a capital asset owned for investment purposes, we need not address

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this issue because of our determination that petitioners have nevertheless satisfied the test articulated in Miller.[2]

Based on our consideration of the entire record, we conclude that petitioner did not have a substantial investment purpose in purchasing and holding the Ranch during the years in issue and is thus not subject to the limitations in section 163(d).

Respondent argues that petitioner's dominant motive was investment. He contends that this conclusion is supported by the Trust Agreement, petitioner's payment of certain surveying costs, a letter from Burns, petitioner's white papers, the Ranch's location near a "booming residential subdivision," and the limited agricultural value of the property.

Respondent also argues that under either the strong proof rule or the Danielson rule, petitioners have failed to introduce evidence that will overcome the intent of the parties as described in the Trust Agreement. The stricter rule of Danielson v. Commissioner, 378 F.2d 771, 775 (3d Cir. 1967), vacating and remanding 44 T.C. 549 (1965), has not been adopted by this Court. See G S Services Corporation v. Commissioner, 73 T.C. 406, 412 n. 2 (1979). Nor has it been applied in the Court of Appeals for the Ninth Circuit, to which this case may be appealed. See Throndson v. Commissioner, 457 F.2d 1022, 1025 (9th Cir. 1972), affg. 51 T.C. 306 (1968).

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[2] Petitioners argue that the use of the property assumed by respondent, i.e., subdivision and resale, would result in taxation at ordinary rates. Because of our holding, we need not address this argument.

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The "strong proof" rule requires a taxpayer to present strong proof, i.e., more than a preponderance of the evidence, that the intended allocation of the purchase price is other than the allocation described in the contract. Major v. Commissioner, 76 T.C. 239, 247 (1981). As respondent correctly points out, the strong proof rule has been applied in situations other than a challenged allocation of purchase price. See, e.g., Schatten v. Commissioner, 746 F.2d 319 (6th Cir. 1984). The language in the Trust Agreement on which respondent relies, however, is merely a recital of intent and not an operative provision. Nevertheless, assuming but not deciding that the strong proof rule applies, we conclude for the reasons set forth in this opinion that petitioners have satisfied the requirements of that rule.

Respondent relies heavily on the provision in the Trust Agreement that described its purpose in terms of subdividing and disposing of the property. Respondent alleges that the parties bargained for such language and that it therefore manifested their mutual intent. There is no evidence, however, of such bargaining, and the testimony of the participants is to the contrary. The Trust Agreement was drafted in accordance with Burns' instructions, and its language generally mirrored other trust agreements prepared for Burns. The Trust Agreement in no way encouraged petitioner to sell parcels, and Burns testified that the division of the property into parcels (and affixed prices) simply secured the interests of the Burns Partnership.

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Moreover, Burns stated that he did not know what petitioner would do with the Ranch.

Petitioner testified that he never intended to sell any parcels and that he wanted to farm the property. His testimony was credible and corroborated by his ranch manager and other witnesses and was consistent with his conduct. Petitioner hired a ranch manager, secured advice from farming consultants, purchased farm equipment, converted a tennis court to a hay barn, farmed the property by growing hay and raising livestock, and maintained certain records of the farming activities.

Respondent also relies on the letter from Burns to petitioner dated July 18, 1977. It described projects on the Ranch that petitioner may have wanted to continue and stated that "I know the resale will be a tremendous success." Even if this statement by Burns suggests an intent by petitioner to resell the property, and we are not convinced that it does, it is nevertheless outweighed by petitioner's affirmative action toward farming the property, his notation at the bottom of the letter that he may buy some of the farm equipment, and Burns' testimony that he did not know what petitioner would do with the Ranch.

Moreover, petitioner has persuasively explained the reasons for the white papers, a security device in case petitioner was short of funds to make payment, and the $25,000 payment of engineering and surveying costs, a part of the consideration required by the seller. Also, the Ranch's mere proximity to a residential subdivision does not indicate an intent by petitioner

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to resell parcels, particularly in view of the objective factors and testimony heretofore discussed.

Respondent contends that the agricultural value of the Ranch was limited because of low historical income, lack of adequate water, and environmental problems. Respondent's expert's report identified the property's highest and best use as ranchettes or rural residential. This determination was based primarily on the zoning of the area, the nearby residential developments, the limited water supply, and the steep upland slopes. This argument is not persuasive; that an expert or, for that matter, any other individual might consider the property undesirable as a farm does not show that petitioner did not intend to farm the Ranch.

In his brief in answer, respondent alternatively argues that petitioners' operation was a "hobby" under section 183. Petitioners object to respondent's asserting a new position on brief and argue that it violates the requirement of "fair notice of the matters in controversy" in Rule 31(a), Tax Court Rules of Practice and Procedure. We agree. Respondent did not raise the issue in his notice of deficiency, in his answer to the petition, or at trial. Because petitioner did not have the opportunity to present evidence on this issue, we do not consider it. See Seligman v. Commissioner, 84 T.C. 191, 198-199 (1985), and cases cited therein, on appeal (5th Cir., Nov. 13, 1985). In any event, respondent's alternative argument is essentially inconsistent with his position that the property was held for investment. See section 1.212-1(b), Income Tax Regulations.

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Interest otherwise deductible under section 163 is not limited by section 183. Respondent did not disallow other deductions relating to the Ranch, and it is those items that would not be allowed by the application of section 183(b)(2).

The second issue for decision is whether petitioners are entitled to casualty loss deductions in 1978 and 1980 in excess of the amounts allowed by respondent in his notice of deficiency.

The amount of a casualty loss deduction is generally computed as the fair market value of the property immediately before the casualty minus the fair market value of the property immediately after the casualty, not to exceed, however, the property's adjusted basis. Millsap v. Commissioner, 46 T.C. 751 (1966), affd. 387 F.2d 420 (8th Cir. 1968); section 1.165-7(b)(1), Income Tax Regs. The determination of these respective values "shall generally be ascertained by competent appraisal." Section 1.165-7(a)(2)(1), Income Tax Regs. As an alternative, the regulations allow the cost of repairs to the property as a measure of the casualty loss. Section 1.165-7(a)(2)(ii), Income Tax Regs. Petitioners admit that they have the burden of proving the amount of the casualty loss deductions. Heyn v. Commissioner, 46 T.C. 302 (1966); Rule 142(a), Tax Court Rules of Practice and Procedure.

In support of the deductions they seek, petitioners argue that the fair market value of the Ranch declined as a result of the casualty. Petitioners rely on two letters and certain testimony. One letter, by a real estate broker, described a loss

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in value of $400,000. The other letter, by a farming consultant, estimated that satisfactory repairs would cost $300,000; however, petitioners admit that they are not seeking to prove cost of repairs as a measure of the damages. Although the drafters of these letters testified at trial, neither was qualified as an expert on appraisal or market valuation. Their statements were unsupported and unpersuasive. Respondent's expert, whose report is a part of the record, determined the Ranch's value in 1977, 1980, and 1985 as approximately $1.3 million, $1.4 million, and $1.6 million, respectively. Petitioners have failed to satisfy their burden of proof.

In his notice of deficiency, respondent allowed casualty loss deductions for 1978 and 1980 consistent with the estimated costs of restoration determined by the local Agricultural Stabilization and Conservation Service office. Because petitioners have failed to prove deductible losses in excess of those amounts, respondent's determinations as to the casualty loss deductions are sustained.

We have considered other arguments of the parties, but because of our holding, we do not address them.

Decision will be entered under Rule 155.

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UNITED STATES TAX COURT

LLOYD V. PEVERILL AND ELIZA M. PEVERILL, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 40374-84. Filed August 6, 1986.

David S. Strutt, for the petitioners.

Rogelio A. Villageliu, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, Judge: Respondent determined deficiencies in petitioners' Federal income taxes as follows:

Year	Deficiency
1980	$ 644.64
1981	1,334.56
1982	1,347.40

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The sole issue for determination is whether petitioners are liable for self-employment tax under section 1401[1] with respect to income received by petitioner husband for services as an ordained minister.[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners resided in Low Moor, Iowa, when they filed their petition in this case.

Petitioner[3] is an ordained minister of the United Methodist Church. Petitioner was graduated from the seminary in 1957 and, since that time, has served full-time as a minister in various parts of the United States. Based on religious principles, petitioner opposes the acceptance of any public insurance which makes payments in the event of death, disability, old age or retirement or makes payments for medical care. As a result,

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1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

2 The parties have agreed in a stipulation of settled issues that the underlying amounts involved in the taxable years in question are as determined in the statutory notice of deficiency. Thus, a Rule 155 computation is unnecessary.

3 "Petitioner" in the singular form hereinafter refers to petitioner Lloyd V. Peverill.

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petitioner objects both to the payment of self-employment tax and the acceptance of social security benefits. Petitioner has no earnings other than from services performed by him as a minister.

In 1958, petitioner attached a signed statement to his timely filed 1957 return which read: "I hereby apply for the exemption from social security or self employment tax as is accorded to ministers." On his 1958 return, petitioner wrote on line 15 of his 1040 return "Minister - Exempt" and attached the same statement filed with his 1957 return. Petitioner did not attach such statements to any other subsequent year's return. With respect to whether an exemption application was filed under section 1401(e), respondent has no record that he received, approved or disapproved an application for exemption from self-employment tax or social security coverage for petitioner at any time prior to, during, or later than the taxable years at issue.[4] Likewise, the Social Security Administration cannot locate any records evidencing petitioner's application for or approval or disapproval of exemption from social security benefits or self-

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[4] Two forms exist under which exemption status can be claimed: Form 4361, Application for Exemption from Self-Employment Tax For Use By Ministers, Members of Religious Orders and Christian Science Practitioners, and Form 4029, Application for Exemption from Tax on Self-Employment Income and Waiver of Benefits. Petitioner would most logically file Form 4361; however, petitioner could also file Form 4029 which applies to individuals who have conscientious objections to insurance due to their adherence to established tenets or teachings of a religious sect. See sec. 1402(g) and sec. 1.1402(h)-1(c), Income Tax Regs. Since petitioner's arguments center on Form 4361, we will focus primarily on Form 4361 in the opinion.

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employment tax. Petitioner failed to produce at trial a retained copy of any exemption application or approval. Petitioner has never paid self-employment tax on his earnings from services performed by him as a minister.

On September 4, 1984, respondent issued a notice of deficiency to petitioners for the taxable years 1980 through 1982. Respondent contends that petitioner is subject to self-employment tax under section 1401 with respect to his services as a minister for the years in question. Petitioners do not dispute the self-employment tax computed by respondent on petitioner's income.[5] Rather, petitioner claims that he is exempt from self-employment tax under section 1402(e).

OPINION

Section 1401(a) imposes a tax on the self-employment income of every individual for old age, survivors, and disability insurance. Section 1401(b) imposes a tax on the self-employment income of every individual for hospital insurance.

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5 Respondent determined the amounts of self-employment tax to be $939.64, $1,343.56, and $1,395.40 for the calendar years 1980, 1981, and 1982, respectively. However, respondent recomputed petitioners' income tax liability for the taxable years in issue and found that petitioners overreported their income tax by $295.00 in 1980, $9.00 in 1981, and $48.00 in 1982. As a result, petitioners' deficiencies are $644.64, $1,334.56, and $1,347.40 for the taxable years 1980, 1981, and 1982, respectively.

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Prior to 1968, ordained ministers were automatically excluded from social security coverage and the self-employment tax.[6] Ministers could elect social security coverage as self-employed persons by filing a Form 2031.[7] In 1968, the statute was amended and ordained ministers were automatically subject to the self-employment tax for taxable years ending after 1967 with respect to services performed by them.[8] Social Security Amendments of 1967, Pub. L. 90-248, 81 Stat. 821, 839.

However, the self-employment income of ministers and certain others may be exempt under circumstances set forth in section 1402(e)(1).[9] Under that section, a minister's self-employment

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Services performed by an ordained minister of the church were excepted from the term "employment" under old sec. 3121(b)(8(A) and from the term "trade or business" under old sec. 1402(c)(4). As a result, ministers were exempt from social security taxes.

7

Sec. 1.1402(e)(1)-1(a), Income Tax Regs.

8

In particular, the House and Senate Reports both state that:

> An individual not electing coverage under present law will be covered under social security for taxable years ending after December 31, 1967, unless he is granted an exemption under the new section 1402(e) of the code. [H. Rept. No. 544 (1967), 1968-1 C.B. 699, 705; S. Rept. No. 744, 1968-1 C.B. 706, 712.]

9

Sec. 1402(e) provides in part:

(e) MINISTERS, MEMBERS OF RELIGIOUS ORDERS, AND CHRISTIAN SCIENCE PRACTITIONERS.--

(footnote continued)

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income may be exempt from self-employment tax if the minister files an application for exemption in a timely manner[10] and as prescribed by the regulations.

(footnote continued from previous page)

(1) EXEMPTION.--Any individual who is (A) a duly ordained, commissioned, or licensed minister of a church or a member of a religious order (other than a member of a religious order who has taken a vow of poverty as a member of such order) or (B) a Christian Science practitioner, upon filing an application (in such form and manner, and with such official, as may be prescribed by regulations made under this chapter) together with a statement that either he is conscientiously opposed to, or because of religious principles he is opposed to, the acceptance (with respect to services performed by him as such minister, member, or practitioner) of any public insurance which makes payments in the event of death, disability, old age, or retirement or makes payments toward the cost of, or provides services for, medical care (including the benefits of any insurance system established by the Social Security Act), shall receive an exemption from the tax imposed by this chapter with respect to services performed by him as such minister, member, or practitioner. Notwithstanding the preceding sentence, an exemption may not be granted to an individual under this subsection if he had filed an effective waiver certificate under this section as it was in effect before its amendment in 1967.

10

Sec. 1402(e) further provides:

(2) TIME FOR FILING APPLICATION.--Any individual who desires to file an application pursuant to paragraph (1) must file such application on or before whichever of the following dates is later: (A) the due date of the return (including any extension thereof) for the second taxable year for which he has net earnings from self-employment (computed without regard to subsections (c)(4) and (c)(5)) of $400 or more, any part of which was derived from the performance of service described in subsection (c)(4) or (c)(5); or (B) the due date of the return (including any extension thereof) for his second taxable year ending after 1967.

We note that petitioner's due date for Form 4361 is no later than the due date of the tax return for petitioners' second taxable year ending after 1967, or April 15, 1970. Sec. 1402(e)(2). Petitioner's Form 4029 due date is December 31, 1968. Sec. 1402(g)(2) and sec. 1.1402(h)-1(c), Income Tax Regs.

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Section 1.1402(e)-2A, Income Tax Regs., states that any individual who is "a duly ordained" minister of a church may request an exemption from the tax on self-employment income with respect to services performed by him in his capacity as a minister. Section 1.1402(e)-2A(a)(1), Income Tax Regs., mandates that:

> Such a request shall be made by filing an application for exemption on Form 4361 * * *.

In addition to the application for exemption, an applicant must file, or Form 4361 must contain, a statement that the applicant is either "conscientiously opposed to" or "because of religious principles is opposed to" the acceptance of public insurance such as social security benefits with respect to his ministerial services. Sec. 1.1402(e)-2A(a)(2), Income Tax Regs. Moreover, in order for an exemption to be in force, the application must be approved by an Internal Revenue officer.[11] The mere filing of a Form 4361 is not sufficient for exemption; approval must be obtained.

Petitioner first argues that he has filed a Form 4361 and, thus, has satisfied the requirements of section 1402(e). Second, petitioner contends that a substitute form has been filed which

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11 Sec. 1.1402(e)-2A(c) states, in pertinent part:

The filing of an application for exemption on Form 4361 by a minister * * * does not constitute an exemption from the tax on self-employment income with respect to services performed by him in his capacity as a minister * * *. The exemption is granted only if the application is approved by an appropriate internal revenue officer. * * * [Emphasis supplied.]

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satisfies the requirements of section 1402(e). Third, petitioner asserts that even if no form has been filed, petitioner satisfies all the requirements of the statute and should be granted an exemption. Finally, petitioner argues that respondent has acquiesced in petitioner's exemption from self-employment tax by not raising the exemption issue from 1968 until 1980 and is estopped from raising the issue now.

Turning to petitioner's first argument, respondent contends that petitioner has failed to meet his burden of proof as to the filing of a Form 4361. We agree with respondent.

Petitioner bears the burden of proof in showing that his Form 4361 was timely filed and that the respondent's determination is erroneous. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Petitioner testified that in 1968, or 1969, his conference superintendent informed him that he should go to the Internal Revenue Service or the Social Security office to make an affirmative election from the social security system. Petitioner cannot remember to which office his superintendent informed him to go. Petitioner signed a form in Waterloo, Iowa. However, petitioner cannot remember any details of the form signed, recall in what office he signed the form, or produce a copy of the form. In fact, it is not clear that petitioner signed a Form 4361 in an Internal Revenue Service or Social Security office. Neither respondent nor the Social Security Administration can find any record of petitioner's Form

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4361 application for or approval or disapproval of exemption status for any year.[12]

Petitioner's recollection is far too vague to be relied upon as evidence of his compliance with the specific and detailed statutory requirements of section 1402(e) and section 1.1402(e)-2A, Income Tax Regs. This Court has rejected such vague testimony as insufficient to carry petitioner's burden of proof.[13] The statute and the regulations clearly establish that the time limitations of section 1402(e) are mandatory and must be strictly complied with.[14] Because a search of respondent's records failed to discover petitioner's Form 4361 and since petitioner failed to carry his burden of proof to show that Form 4361 was filed and approved, we find that petitioner did not timely file a request for exemption as required by section 1402(e).

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Any filed Forms 4361 are maintained alphabetically and, until early 1986, were kept indefinitely. I.R.M., Records Administration par. 110(5)77, and Correspondence par. 35(44)(36)(9)(b)(6). Presently Form 4361 is kept for 75 years from the date of waiver. I.R.M. 1(15)59.26, Records Control Schedule 206 for Service Centers, Exhibit 100-1 Cont. 8, item 77, at page 1(15)59.26-17, 18.

13

LeMaster v. Commissioner, T.C. Memo. 1984-184, affd. 767 F.2d 924 (7th Cir. 1985).

14

Treadway v. Commissioner, T.C. Memo. 1984-153.

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Petitioner also attempts to refute his liability for self-employment tax by contending that the written statement attached to his 1957 and 1958 return and the "Minister-Exempt" statement in his 1958 return satisfy the requirements of section 1402(e). Section 1402(e) and the regulations thereunder set forth a comprehensive and mandatory procedure to be followed by ministers who wish to obtain an exemption from the self-employment tax.[15] While petitioner may meet the substantive requirements for an exemption, he has not complied with the procedural requirements of section 1402(e) and the regulations.[16] Moreover, in his 1957 and 1958 statements, petitioner makes no assertion that he is either "conscientiously opposed to" or "because of religious principles is opposed to" the acceptance of public insurance such as social security benefits with respect to his ministerial services. Thus, even if petitioner's 1957 and 1958 statements could be viewed as timely filed, the statements are legally insufficient to meet the statutory requirements necessary to

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Treadway v. Commissioner, supra; Devine v. Commissioner, T.C. Memo. 1980-511, affd. without published opinion 673 F.2d 1335 (7th Cir. 1981); see also Allinson v. Commissioner, T.C. Memo. 1979-405; McLanahan v. Commissioner, T.C. Memo. 1979-373.

16

We have reviewed petitioner's cited cases on this point and find them unpersuasive. All the cases involve situations in which the Court found that an application had been filed or evidence pointed to a timely mailing of the form in question. See, e.g., Robertson v. Commissioner, T. C. Memo. 1983-32, affd. without published opinion 742 F.2d 1446 (2d Cir. 1983). Petitioner has not sustained his burden of proof on the filing of Form 4361 and, thus, there is no presumption of filing.

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obtain an exemption. Sec. 1402(e)(1); sec. 1.1402(e)-2A(a)(2), Income Tax Regs. As a result, petitioner's second argument fails.

Petitioner also asserts that even if no Form 4361 has been filed, he satisfies all the requirments of the statute and should be granted an exemption. While we do not question the sincerity of petitioner's beliefs, section 1402(e) provides strict limitations for the timely filing of an application for exemption. It is not sufficient simply to possess the requisite religious beliefs.[17] Ballinger v. Commissioner, 78 T.C. 752, 757 (1982), affd. 728 F.2d 1287 (10th Cir. 1984).

Finally, petitioner argues that respondent has acquiesced in petitioner's exemption from 1968 until 1980 and is thus estopped from raising the issue now. Petitioner's argument of estoppel must fail. The mere acceptance or acquiescence in returns filed by a taxpayer in previous years creates no estoppel against respondent nor does the overlooking of an error in a return upon audit create any such estoppel. Rose v. Commissioner, 55 T.C. 28, 31 (1970).[18]

On the basis of the record, petitioner has failed to carry his burden of proof that he filed and received approval of Form 4361 qualifying him for exemption from self-employment tax under

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17 Kelly v. Commissioner, T.C. Memo. 1980-37, affd. without published opinion 644 F.2d 879 (4th Cir. 1981).

18 Holland v. Commissioner, T.C. Memo. 1983-717.

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section 1401(e) and the regulations. Since petitioner's burden is not met, we find that petitioner did not satisfy the requirements of section 1402(e) for exemption from payment of the self-employment tax and, as a result, owes self-employment tax on his income received for his services as a minister during the taxable years in question.

To reflect the foregoing,

Decision will be entered for the respondent.

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T. C. Memo. 1986-355

UNITED STATES TAX COURT

ROBERT L. AND LEONA M. CHESTER, ET AL., Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 14299-84, 14324-84, 14325-84, 14328-84, 14329-84, 15227-84, 15228-84, 15240-84, 15915-84, 15916-84, 15932-84, 15933-84, 20675-84, 22153-84, 22336-84.

Filed August 6, 1986.

Robert F. Hatfield, for the petitioners.

Rebecca W. Wolfe and Deborah A. Butler, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

DRENNEN, Judge: These cases were consolidated for purposes of trial, briefing, and opinion. Appendix A sets forth petitioners by name and docket numbers, the tax years involved, the deficiencies for each year, and the place of residence of each individual petitioner. Each of the petitions includes, among other issues, the common issue of the tax consequences of the investment by petitioners in video tapes with religious

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themes claimed to have been produced by Jesus Is Lord Ministries (JLM), sold to petitioners by DanKryst, a corporation, formed and owned by Dan Chester, and marketed by SWEET, a corporation formed and operated by Ron Davis. In his statutory notice, respondent disallowed each petitioner's depreciation deductions,[1] interest deductions, and investment tax credits incurred as a result of their investments in the JLM tapes.[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts along with the supplemental stipulations of facts and attached exhibits are incorporated herein by this reference. The pertinent facts are summarized below.

Jesus is Lord Ministries (JLM), is a non-profit organization incorporated in the state of Arkansas in February 1977 as the result of a merger between Jesus is Lord Foundation and the Charles Thompson Evangelistic Association. The principal place of business of JLM was listed in the merger documents as Hardy, Arkansas. The stated purpose or purposes for which JLM was formed were described as "charitable, benevolent, educational, religious, missionary, evangelistic and other religious activities." Charles W. Thompson (Thompson), was listed as the

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1/ Appendix C lists the deductions, credits, and losses taken by each petitioner.

2/ There is also an additional issue in Docket #14325-84 involving the disallowance of a charitable contribution deduction.

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president and resident agent of JLM. Rena Walters (Walters), was the secretary/treasurer of JLM and Bernice Thompson was the vice president.

Thompson had worked as a Methodist minister for about 15 years in northern Arkansas. He was ordained as an elder in the Methodist Church. After organizing JLM, Thompson conducted tent crusades[3/] from May through October in Arkansas, and also in Kentucky, Louisiana, Illinois, Tennessee, Alabama, Mississippi, Georgia and Missouri. In addition to its tent crusades, JLM operated a thrift shop, a Christian bookstore, a Christian school, and held religious seminars in Hardy, Arkansas. From 200 to 600 people would attend each tent crusade and from 800 to 1,000 would attend the seminars held twice a year. JLM compiled a mailing list of seven to eight thousand persons based upon those individuals who attended the tent crusades and seminars.

Petitioner Daniel Chester (Chester), served as Associate Director for JLM from 1978 to the spring of 1984. Sometime in the late summer or early fall of 1980 Thompson asked Chester to contact John Williams (Williams). Williams was described to Chester as a Christian financial consultant. Thompson had learned of a tax shelter program marketed by Williams in Arizona involving audio cassettes and wanted Williams to discuss this

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3/ Tent crusades are religious services conducted by a travelling evanglist. They are so called because they are literally held in a tent that is transported from site to site.

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program with JLM.[4/] Chester contacted Williams and invited him to come to Arkansas to speak with JLM representatives. A meeting with Williams was held in the fall of 1980 attended by Thompson, Walters, Ron Davis (Davis), and Gary Chester (Gary), Daniel's son. Williams explained to those present his concept of marketing audio cassettes to utilize investment tax credits.

After meeting with Williams, several JLM representatives met with several representatives of the Internal Revenue Service (IRS), in Little Rock, Arkansas. The JLM representatives discussed with the IRS the possibility of obtaining investment tax credits on religious master video recordings ("MVR" or "tapes"). Specific details of JLM's plan were not discussed and no tapes were shown to the IRS. The meeting lasted about 20 minutes. The JLM representatives left the meeting with the belief that their proposal qualified for an investment tax credit. The IRS however refused to give the JLM representatives written approval of their plan. Gary testified that a verbal

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4/ In Call v. Commissioner, T.C. Memo. 1985-318, we denied deductions and credits claimed by taxpayers involved in tax sheltered investment programs, very similar to the one here involved, marketed by Williams in Arizona. As we noted in Call, Williams was sued by the State of Arizona on behalf of the taxpayers in Call for civil and criminal securities fraud and for false pretenses. A $5,800,000 judgment was entered against Williams on the civil charges. Williams pleaded guilty to the criminal charges and was in prison at the time of the trial of this case.

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legal opinion approving JLM's plan was later obtained from C.P. Christian (Christian), an attorney from Jacksonville, Florida, who specialized in criminal law.

JLM then developed a tax shelter plan similar to the one described to them by Williams but utilizing MVR. JLM wanted to make Christian programming available to low power television stations for family entertainment and education. To prepare for this endeavor, JLM members read articles and magazines but felt that their investment was in a "pioneering, virgin field." Prior to this time, JLM had never been involved in the production of MVR. On November 5, 1980, a special meeting of the JLM Board of Directors was called to approve the video program which JLM called "The Video Ministry." JLM set a goal of producing 30 tapes in 1980. Thompson was to be hired as one of the artists to make the tapes. For his services, Thompson was to receive royalties of 20 percent of the selling price of each tape. The royalties were to be paid[5/] at the rate of 10 percent of the income received from the sale of the tapes up to a maximum of $50,000 per year. JLM then sold the tapes to DanKryst, an organization established by Gary Chester to sell the tapes to individual investors. Names of potential investors were obtained from JLM's mailing list. Parkin Printing Co. was first

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5/ The use of the terms "paid," "payment," "purchase," or "investment" are used for convenience only and are not intended to represent any conclusion concerning the true nature of the transaction at issue.

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approached to market the tapes. After Parkin Printing Co. declined, Ron Davis, who worked for Parkin Printing Co., was recommended to market the tapes. Davis formed SWEET, Inc. (SWEET), to market the tapes. The tapes were produced sometime subsequent to October 1980.6/ One of JLM's employees, Dave Keylor (Keylor), operated the video equipment used to make the tapes.

Formation of DanKryst, Inc.

Gary was a high school graduate with one year of college courses. While in college he took two accounting courses. During the time he was associated with JLM, he was working as a tax return preparer in Hardy, Arkansas. Prior to that time he had worked as a bookkeeper for Plough Corp., an industrial corporation, reconciling corporate bank accounts. He also worked at one time for an accounting firm.

DanKryst was an Arizona corporation incorporated under the name Don Lyon, Inc. on September 22, 1980. Gary purchased the corporate shell of Don Lyon, Inc. from Williams. On July 13, 1981, an "Amendment to the Articles of Incorporation" was filed with the State of Arizona changing the name of Don Lyon, Inc. to DanKryst, Inc.7/ A "Statement of Foreign Corporation Seeking

6/ This is according to Daniel Chester's testimony. Respondent however questions whether the tapes were actually produced in 1980.

7/ Stipulated into evidence are numerous contracts between JLM and DanKryst for the sale of various tapes all dated December 3, 1980.

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Authorization to do Business in Arkansas" was filed with the Secretary of the State of Arkansas on June 15, 1982. Gary was listed as the corporate president and resident agent. Gary held 51 percent of the DanKryst stock while his wife held the other 49 percent. Gary and his wife were the only members of DanKryst's Board of Directors but they did not hold any meetings.

During the fall of 1980, DanKryst (or Lyon), entered into agreements with JLM for the purchase of 30 tapes.8/ Each tape was purchased for $95,000. None of these tapes were copyrighted. The purchase price of $95,000 was suggested by Williams; Gary did not attempt to negotiate with JLM concerning the price. The agreements called for cash downpayments of $5,000 and a $90,000 note at 7.5 percent annual interest for each tape. DanKryst paid JLM a $100 downpayment for each tape with the remainder of the downpayment due within one year of execution of the note. Gary signed the notes for DanKryst. When the notes were signed DanKryst had no assets except for a minimal amount of cash. The total purchase price for the 30 tapes was $2,850,000. Prior to purchasing the tapes from JLM, Gary did not contact anyone involved in the production, or marketing of religious video tapes to determine the costs to produce such tapes, or whether there was a market for the tapes. Neither did he seek an appraisal with respect to the tapes.

8/ JLM also sold tapes to an organization called I Peter 1:25 ("First Peter"), and one called Cyndrea, Inc. ("Cyndrea").

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In December of 1980, DanKryst began selling the tapes to investors. The price for each tape was $100,000. Prospective investors learned about the tapes through Thompson who discussed the tapes at JLM's tent crusades, or through Gary, Daniel, or Everett Croslow, who acted as sales representatives for DanKryst. Prospective investors were shown a copy of section 38,9/ and were advised that the tapes qualified for investment tax credits. They were also asked to make their tax returns for the three prior years available so that the amount of investment tax credit they could earn, and utilize, by investing in a tape could be computed. Using these prior tax returns, the total amount of Federal income taxes paid and recoverable through use of the investment credit and carrybacks was calculated for each potential investor. This amount was determined to be the investor's 10 percent cash downpayment, which was then multiplied by 10 to determine the total amount of the investor's investment in the tapes. If the investment was to be less than $100,000, the investor was sold a percentage of one tape. If it was more than $100,000, the investor was sold one tape and a percentage interest in an additional tape. None of the investors was asked to present a financial statement.

9/ All section references are to the Internal Revenue Code of 1954, as amended, and in effect during the taxable years at issue.

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Davis was present at meetings with prospective investors and discussed with them his strategy for marketing the tapes which included pooling all the income from exploiting all the tapes so that all investors would share in the income from the tapes based upon their respective percentages of ownership. None of the investors attempted to negotiate the purchase price for their tapes, or their repayment schedules.

To purchase a tape, each investor had to complete a "General Installment Sale and Security Agreement" (the "agreement"), and a "Full Recourse Promissory Note (the "note"). Forms for these documents were given to Gary by Williams. The purchase price in each agreement was $100,000 per tape. The payments under each agreement consisted of a cash downpayment of from $10 to $100,10/ the balance of the downpayment due on receipt of the investor's tax refunds due to investment tax credit carrybacks from the three prior years, and a final payment as set out in the note incorporated by reference. The agreement required that each debtor maintain insurance on his or her tape. Testimony by several representative investors indicated that none of the investors obtained such insurance. Each investor was to indicate whether his or her collateral (i.e., tape), was to be used for personal or business purposes, and where the collateral was kept. None of this information was supplied by any of the investors.

10/ Once DanKryst received an investor's downpayment, it forwarded 50 percent of the downpayment to JLM as its downpayment to JLM.

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Each note was signed only by the investors and recited that it was "made and delivered in accordance with that purchase agreement of even date thereof, the terms of which are by this reference incorporated herein." The investor's debt obligation was secured by a security interest in the tape. After a note was signed, following Williams' advice, Gary returned it to the maker with the understanding that if the notes were needed by DanKryst the makers were to return them to DanKryst. When the IRS began its investigation of the MVR investment program, Gary asked the investors to return the notes to DanKryst, or to execute a new note if the note had been misplaced.

If the investors failed to repay the notes Gary testified that he had three options including: 1) refinancing the notes; 2) repossessing the collateral; or 3) suing for collection on the note. Because of his personal relationship with the investors, the only option Gary ever exercised was to repossess tapes from several investors who wanted to be released from their investment when a split occurred within JLM.

Formation of SWEET, Inc.

Davis graduated from high school in California and shortly thereafter began managing a furniture store. In 1975, after working in a management capacity in several different businesses, he moved to Arkansas and worked as a division manager for Capitol Business Machines, investigating the market for copy machines. At the time JLM was developing its tax shelter plan, Davis was

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employed as director of marketing in charge of sales for the equipment division of Parkin Printing Co., an office equipment firm. Davis was also a member of National Office Machine Dealers Association (NOMDA). As a member of NOMDA, Davis often spoke at seminars discussing how to organize or run a business.

On March 3, 1981, Davis formed a corporation named SWEET (Spiritual Wealth Everyone's Entitled To).11/ Davis is the only officer of SWEET and owns 30 of its 1,000 shares of stock. When Parkin Printing Co. decided not to market the video tapes produced by JLM Davis formed SWEET to do so because he felt obligated to the investors to market their tapes and he also believed that the market for Christian video tapes held great promise due to the expansion of low power television and the growing video market. To market the tapes, Davis established the SWEET Library of Tapes (the "library"). The library made tapes available for sale or rental to those individuals who were members of the library. Davis sold charter memberships in the library for $250. Student memberships were available for $65. No list was maintained of the memberships sold, or of individuals who rented or purchased the tapes, or how much income was received from each tape. Records were maintained as to the total income from the tapes and equipment which amounted to $7,468.51

11/ Davis stated that he formed SWEET in 1980. However the evidence shows that the formation may not have been valid until March 3, 1981, at which time Davis removed his children from their positions as officers of SWEET.

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total for 1981, 1982, and 1983, of which $2,624.43 came from individuals outside the investment program. Davis also utilized direct mailings of a list of the tapes available as a marketing tool. Davis kept the tapes in his possession. He did not insure the tapes but instead made a copy of the tapes and stored them in his attic in a foot locker. Davis did not take any of the tapes to an appraiser to ascertain their quality. Nor did he show the tapes to any television stations to determine whether the stations would broadcast the tapes. He was not concerned with the quality of the tapes due to the market he was after.

The first agreements signed by investors using SWEET as a marketing agent were not signed until the spring of 1981. These original agreements titled "Video Systems Marketing Contract" referred to each investor as the lessor and to SWEET as the agent. The agreement provided that the investor was to pay SWEET $295[12]/ as an origination fee and lease his tape to SWEET for seven years. SWEET was to market the tape for seven years holding all the proceeds from the tape in trust for the investor. The proceeds were to be placed in a pool and divided among the investors according to their respective percentages of ownership. Fifty percent of the pool's proceeds were to go to DanKryst as payment on the investors' accounts with DanKryst, and the

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[12]/ This fee was actually paid to SWEET by DanKryst.

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remainder was to be retained by SWEET as consideration for its services. Each investor also had to sign an "editing format" detailing what was to be done to his or her tape.

The original sales agreements were modified in 1983 and 1984 when SWEET sent new marketing contracts to the investors. The form of the contracts was changed because of questions raised by the IRS and some of the investors concerning the contract's reference to each investor as "lessor." The new contracts were each entitled "Master Video Recording Marketing Contract." These contracts, executed in 1983 and 1984, were backdated to 1980 and 1981, respectively. These contracts provided for a term of five rather than seven years; referred to each investor as "producer" instead of as "lessor"; provided that funds received by SWEET for editing the tapes were included in the pool to be divided amongst the investors; increased SWEET's marketing fee to $1,500 for a $100,000 tape; and provided that the contracts could be renewed at SWEET's option rather than at the investors. No additional marketing fees were paid to SWEET after the execution of these new contracts. Davis stated that the tapes made in 1980 had to be copied shortly thereafter because they were originally taped in a "Beta I" format which became outdated.

SWEET also agreed to edit the tapes in return for payment by JLM of an editing fee.[13/] The editing fee was $250 per hour

13/ Respondent argues that little or no editing was ever performed on the tapes.

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which resulted in a fee of $24,000 per tape. JLM paid the editing fees without questioning what was done to each tape. Davis stated that it took 90-120 hours to edit each tape. SWEET kept a certain percentage of the editing fees and placed the rest in the income pool to be distributed to the investors. He said SWEET purchased most of the equipment it utilized in editing the tapes. Davis testified that he had spent about $300,000-400,000 on this equipment.

Sometime in 1982 or 1983, JLM prepared "Production Costs Summary Reports" for each tape sold in 1980. All of these reports were essentially identical and listed the following charges:

Film Costs	$ 40.69
Copy Costs/Prep. Material	100.00
Studio Costs - Rent/Use	400.00
Star/Actor Compensation	19,000.00
Filming Crew Wages	200.00
Travel/Food/Lodging/Etc.	10.36
Editing Costs	24,000.00
Miscellaneous - G&A	600.00

In 1981 SWEET's books reflected income of $146,452.79 from the video program, of which $144,000 was received from JLM as editing fees. The library did not prove very successful; income from library memberships and rentals amounted to only $2,452.79. Of this amount, $517.86, was received from DanKryst. In 1982 SWEET received $2,491 for rentals of video equipment and tapes, of which $1,889.41 was received from individuals involved in the promotion of the video program. In 1983, SWEET received

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$2,524.74 for rentals of video tapes and equipment. All of this money was received from individuals involved in the promotion of the video program.14/

Several of the petitioners testified on behalf of petitioners at the trial, including Ledford, Guzman, Strader and Daniel Chester. From their testimony we make the following objective findings of fact.

The investors for the most part lived in the state of Arkansas. A few of them held college degrees, such as Ledford (vocational education), and Guzman (nursing), but others, such as Chester and Strader had received no formal education beyond the high school level. Some of them had held responsible managerial type jobs and had accumulated property, such as Chester ($600,000), and Ledford ($200,000), while others had very little net worth at the time they signed the notes, such as Guzman, who signed a note for $140,000 when she had a net worth of $21,000, and Strader, who signed a note for $30,000 when he had a net worth of $10,000. None of them had any experience in producing or marketing video tapes or knew how much a tape might rent for. Very few of them made any investigation or inquiry about the possibility or probability of making a profit in such a venture. Very few of them ever viewed the tapes they obstensibly purchased or even knew where the tapes were. They did not negotiate the

14/ Rentals of tapes and equipment to individuals not involved in the promotion of the video program totalled no more than $2,624.43 for the years 1981, 1982, and 1983.

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terms of the transactions and had little or nothing to do with the tapes after they were acquired, except entering into marketing agreements with SWEET.

Some of the investors hoped that they might make a profit from participating in the program, but they had no facts or figures upon which to base such a hope. They were relying on the possibility that low power television stations could cause the video business to prosper, but this did not materialize.

Many of the investors were followers of Charles Thompson and wanted to help his evangalistic program. All of them were aware of the tax benefits they thought were available through participation in the program, and this was their predominent motive in participating. While all of them would have welcomed a profit from the activity, making a profit was not their primary objective in entering the program. None of them reported a profit on their investments after deducting depreciation and interest.

Respondent offered the testimony of a well qualified expert witness, Gloria R. Mosesson, on the value of the tapes. She had considerable experience in the literary and publishing fields, including technical editing, selecting and editing books for publication, negotiating contracts for subsidiary rights, producing records, audio cassettes and audio/visual materials, and evaluating the costs involved in producing an item. Mosesson prepared an appraisal of the tapes produced by JLM. She viewed

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each of the tapes to evaluate their content, quality and cost basis. She spoke with various individuals in the technical field of audio/visual production, but she has never produced a video tape herself. She also examined the contracts, promissory notes, agreements, and promotional materials used by SWEET and JLM. In making her appraisals she used techniques established by the American Association of Appraisers. She based her evaluation of the costs to produce the tapes upon her own knowledge. However, she did not receive or incorporate in her appraisals any figures concerning income earned per tape or sales per tape because it was not available to her. In Mosesson's opinion, the tapes had a zero value.

Petitioners offered the testimony of Tom Ferstel concerning the value of the tapes. While Ferstel was well qualified as an appraiser, most of his experience in appraising had been in the field of real estate. Ferstel testified that he did not feel qualified to appraise an MVR but that the techniques used should be the same. He was critical of the methods and information relied on by Mosesson.. Ferstel did not give an opinion of the value of the tapes and petitioners offered no expert evidence on that subject.

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IRS Investigation

In June 1983, Charles Schnebelen (Schnebelen), an examining agent in the Exempt Organization Branch, was assigned to audit the SWEET corporate tax returns, and the individual return of Gary Chester. As a result of his investigation, the Abusive Tax Shelter Committee of the IRS determined that a further examination was warranted to determine whether the program was an abusive tax shelter pursuant to sections 6700 and 7408. Schnebelen was then also assigned the returns of Davis, DanKryst, and First Peter. Cyndrea was also under investigation at this time. As a part of his investigation, Schnebelen sent a notification letter to each of the individuals involved informing them of the investigation and seeking to set up a meeting. After examining records obtained, either through summons proceedings or voluntarily made available, Schnebelen found evidence of an elaborate money circle involving SWEET, DanKryst, First Peter, Cyndrea, and JLM. Other than the relatively small amounts earned from tape or equipment rentals the only money received by these entities from outside sources were the downpayments received from petitioners. Funds were transferred[15] from one organization to another until a complete circuit had been made.[16] Each transfer

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15/ Beginning in 1982, these funds were transferred by wire transfer.

16/ For example, on September 12, 1981, DanKryst paid $12,000 to JLM on its notes. JLM paid $12,000 to SWEET. SWEET then paid $10,875 to DanKryst.

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resulted in a credit of income to the investors' accounts. DanKryst received downpayments from the investors when they received their tax refunds due to investment tax credit carrybacks. DanKryst made payments to JLM on the notes it issued to JLM. JLM then paid SWEET editing fees. SWEET then paid DanKryst services costs.17/ During 1982, DanKryst, First Peter, and Cyndrea, transferred funds totalling $1,353,999.76 to JLM. JLM transferred funds totalling $1,287,648.68 to SWEET. SWEET put 10 percent of the funds in its general operating account and then transferred $1,189,021.48 to DanKryst, Cyndrea, and First Peter. Schnebelen's investigation resulted in notices of deficiency being sent to petitioners disallowing their deductions and credits taken in connection with the purchase of an MVR from DanKryst.

OPINION

The first issue for our decision is whether petitioners are entitled to deductions for depreciation and interest and an investment tax credit for the year 1980 as a result of their investments in the video tapes.18/

17/ SWEET issued Forms 1099 to the investors that reflected that the amounts transferred to DanKryst were income from the MVR.

18/ The deficiencies for the years 1977, 1978 and 1979, and in some cases for the years 1981 and 1982, are based on disallowances of carrybacks and carryforwards of unused losses and credits claimed for the year 1980.

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Petitioners contend that their purchases of the tapes were with the objective of making a profit and therefore their investments are deductible under sections 162, 212, 163, 167 and 183. They liken their activity to that of an investment in an oil well where "higher expenditures are necessary with a very low expectation of profit."

Respondent on the other hand contends that the video program invested in by petitioners was a sham, totally lacking economic substance, and that petitioners did not have a bona fide objective of making a profit, and therefore are not entitled to their claimed deductions, losses and credits. Respondent further contends that the deductions and credits are not allowable because the promissory notes signed by petitioners were in fact non-recourse notes, and petitioners were not "at risk" for the face value of the notes or the interest thereon. Respondent also contends that the tapes were not in existence in 1980 and thus would not support a deduction for depreciation or an investment credit for 1980. For these and other reasons respondent concludes that his determination should be sustained.

We agree with most of respondent's arguments but need not take the time to discuss all of them. A summary analysis of the JLM program illustrates why.

JLM was supposedly the producer of the tapes, although there is no evidence that anyone in the organization had had any experience in the recording business. The purported cost of

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producing a tape was less than $50,000, $24,000 of which was paid to SWEET for "editing" the tapes and $19,000 of which was paid as compensation to the "star/actor" who made the recording. Small amounts were paid for other costs of production.

JLM sold the tapes to DanKryst for $95,000 each, payable $100 or less in cash at the time of the sale, the balance of a $5,000 cash downpayment due within one year, and the balance of the cost represented by a $90,000 note.

DanKryst then sold the tapes to petitioners-investors for $100,000 per tape, payable $100 or less in cash at the time of sale, the balance of the approximately 10 percent downpayment due when the investor received a refund of his taxes, and the balance of the purchase price was represented by a "Full Recourse" promissory note due in seven years. While the note was designated "Full Recourse" nothing was said as to the meaning of those words. The agreement attached to the note mentioned only the obligor's interest in a tape or tapes as the security for the note. Petitioners' investments were determined by the total tax savings and refunds that could be realized by each investor by claiming an investment credit for the year 1980 of 10 percent of his investment and carrying back any unused portion thereof to claim a refund of taxes paid for the years 1977, 1978 and 1979. If the investors' recoverable amount was $10,000, his investment was $100,000 for one tape; if it was only $7,000 his investment was $70,000 for a 70 percent interest in one tape.

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Petitioners-investors then entered into agreements with SWEET to market the tapes for $295 each. SWEET was to pool all of the income from leasing the tapes in trust and pay 50 percent thereof to DanKryst to be applied on petitioners' obligations to DanKryst, with the remaining 50 percent being retained by SWEET as compensation for "services."[19] We have no explanation of the terms of these agreements with the customers or how much rental would be charged for use of a tape. The evidence does indicate that the total income from the tapes and equipment totalled $7,468.51 for 1981, 1982 and 1983, of which only $2,624.43 came from individuals outside the investment program.

Apparently no one connected with the program was called upon to put up any cash except for the small cash downpayments made by petitioners-investors at the time they bought the tapes and the cash received by petitioners on their claims for refund based on the carrybacks of the losses and credits related to their claimed investments in this program in 1980. This cash was then circulated amongst the participants to give the appearance of activity in the various accounts. When petitioners received their refunds, the cash was turned over to DanKryst to apply on to their accounts (about 10 percent of the total account). DanKryst retained a small amount of the cash and turned the balance over to JLM to apply on DanKryst's indebtedness to JLM.

19/ This provision was subsequently changed so that SWEET turned all of the proceeds from editing the tapes over to DanKryst to apply as above, but was to be paid $1,500 per tape for services.

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JLM in turn paid over a part of this cash to SWEET as compensation for editing the tapes and for services,20/ and presumably paid some of it to the people who recorded the tapes. While petitioners' accounts were credited from time to time with payments of interest and principal, they received no actual cash that they used to pay this indebtedness. As will be discussed, supra, the tapes themselves were of very little value, certainly nowhere near the price tag of $100,000 which was used as a basis for the program.

While it might be possible for investors to make a profit out of an activity such as this if the tapes were professionally produced and marketed using subjects and actors that would attract the attention of the general public, it was not realistic to believe that these investors could make a profit out of this activity. The 30 tapes involved here would undoubtedly saturate the limited market for which they were designed and all indications are that they were not well made. To expect their tapes to produce $3,000,000 in revenue over and above the interest that was supposedly accruing on the notes, and other costs, in a period of seven years would have been wishful thinking.

20/ We do not have adequate proof of how these funds were divided.

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This program appears to have been a carefully designed "no lose" venture for all the participants except the United States Government. JLM apparently received a large amount of the cash that was generated by the refunds, and also received some publicity for its evangalistic program. DanKryst presumably received and retained a part of the refunds and had little or no expense. SWEET also received and retained a good share of the refunds and some of the income produced by the tapes for editing, services and commissions, without much expense. None of them had anything to lose and we surmise that if the program broke down all of them would just walk away from it without trying to collect any of the receivables owed them on paper. Many of the investors had insufficient income or assets, aside from that produced by the tapes, to pay the notes. Furthermore, there is no evidence that anyone has tried to collect either principal or interest on the notes up to the time of trial. Perhaps Uncle Sam's largesse has been sufficient to mollify the creditors to date -- or perhaps they never expected to be paid in full.

Based on the above scenario, we must conclude that there was no economic substance to the transactions upon which petitioners rely to support their claimed deductions and credits. The notes petitioners gave to DanKryst were not actually recourse notes and did not represent true indebtedness. The face values of the notes were far in excess of the value of the tapes designated as

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security for payment of the notes and did not represent payment for or an investment in the tapes. Nor did they represent obligations upon which interest would accrue.

The above conclusion might be enough to bring our inquiry to a close with a decision for respondent. See Knetsch v. United States, 364 U.S. 367 (1960); Moore v. Commissioner, 85 T.C. 72 (1985); Brannen v. Commissioner, 78 T.C. 471, (1982) affd,722 F.2d 695 (11th Cir. 1984); Grodt & McKay Realty Co. v. Commissioner, 77 T.C. 221 (1981). However, we believe it would be more judicious to consider some of respondent's other arguments in support of his position.

Respondent also contends that petitioners did not have bona fide objectives of making a profit, and therefore are not entitled to their claimed losses and deductions under sections 162 or 212. In order to constitute a trade or business for purposes of section 162(a) or an activity engaged in for the production of income under section 212, an activity must be carried on in good faith with the actual and honest objective of making a profit. Dreicer v. Commissioner, 78 T.C. 642, 646 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); Fuchs v. Commissioner, 83 T.C. 79, 97-98 (1984); Dean v. Commissioner, 83 T.C. 56, 73-74 (1984); Allen v. Commissioner, 72 T.C. 28, 33, (1979).

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The issue of whether a taxpayer possesses the requisite profit motive is one of fact to be resolved on the basis of all the evidence in the case. Sutton v. Commissioner, 84 T.C. 210, 221 (1985); Surloff v. Commissioner, 81 T.C. 210 (1983); Fox v. Commissioner, 80 T.C. 972, 1007 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984). In making this determination, more weight must be given to the objective facts than to the taxpayer's mere after-the-fact statements of intent. Thomas v. Commissioner, 84 T.C. 1244, 1269 (1985); Engdahl v. Commissioner, 72 T.C. 659 (1979). Petitioners bear the burden of proving that they possessed the requisite profit motive. Welch v. Helvering, 290 U.S. 111, 115 (1933); Rule 142(a). In addition, since no partnership is involved, the intent of each petitioner is determinative.

Section 183 provides generally that, except as otherwise provided for in that section, individual taxpayers will not be allowed a deduction for activities that are "not engaged in for profit." An activity "not engaged in for profit" is defined in section 183(c) as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212."

Section 1.183-2(b), Income Tax Regs., provides several criteria for assisting in making such a determination, including the following:

(1) Manner in which the taxpayer carries on the activity;

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(2) The expertise of the taxpayer or his advisors;

(3) The time and effort expended by the taxpayer in carrying on the activity;

(4) Expectation that assets used in activity may appreciate in value;

(5) The success of the taxpayer in carrying on other similar or dissimilar activities;

(6) The taxpayer's history of income or losses with respect to the activity;

(7) The amount of occasional profits, if any, which are earned;

(8) The financial status of the taxpayer; and

(9) Elements of personal pleasure or recreation in the activity.

Initially, we must state that we are impressed with petitioners' sincerity concerning their religious beliefs and their desire to help JLM. Most of them lived in Arkansas. They were not wealthy people with high incomes. Many of them were followers of Charles Thompson. Some of them had had experience in business but none similar to the marketing of MVR.

However, the fact that petitioners were motivated in part by a desire to help JLM "spread the gospel" does not satisfy the requirement that petitioners had a profit motive. The evidence indicates that most of petitioners were interested in assisting Thompson's evangalistic program, that they were aware of and

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interested in the current tax savings that would be available through participation in the program, and that they gave little or no thought to how or whether they could make an economic profit by participating. While all of petitioners testified that they intended to make a profit, the objective facts indicate otherwise.

Testimony by the representative petitioners Chester, Strader, Ledford, and Guzman, indicated that none of petitioners conducted their purchase of the tapes in a businesslike manner, nor were they concerned with considerations that typically affect a sincere investor. See, e.g., Flowers v. Commissioner, 80 T.C. 914, 933 (1983). None of petitioners even viewed their recordings before they purchased them. None of them sought an independent appraisal of the tapes. They did not attempt to ascertain whether there was a market for the tapes. They did not seek investment advice concerning their purchase other than to discuss their purchases with the JLM representatives who admittedly had an interest in persuading petitioners to purchase the tapes. All of petitioners were essentially passive investors.

None of petitioners attempted to negotiate their contract or its terms, or to question whether they were paying a fair price for the tapes. Several of petitioners had been trained in the use of audio/visual materials but none of them had any experience

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in the production or marketing of MVR. None of petitioners investigated the backgrounds of Davis, Gary, or any of the other JLM representatives.

To our knowledge, none of petitioners kept formal books or records with respect to their investments. None of them were aware of how many times their tapes would have to be rented or sold for them to make a profit, and at the trial of this case, none of them knew whether their tapes had actually been rented or sold. The tapes, supposedly worth $100,000, were not even insured. It is apparent from our reading of the record, that petitioners' activities relative to the tapes had none of the "trappings of a business." Bessenyey v. Commissioner, 45 T.C. 261, 274 (1965), affd. 379 F.2d 252 (2d Cir. 1967).

None of petitioners reported a profit from their investment and due to the deductions and credits taken in connection with their investment, petitioners reported far less tax liability than they otherwise would have reported. Indeed they all incurred losses as a result of their investments. 21/ In addition, none of petitioners questioned SWEET as to what it was doing to market the tapes. While evidence was presented that SWEET sent out periodic newsletters, none of these newsletters discussed specific details of SWEET's marketing of the tapes.

21/ See Appendix C which lists the deductions and credits taken by each petitioner, and the losses reported.

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We recognize that since the production and marketing of the tapes was a relatively new field it would be difficult to find persons with a great deal of expertise in this area. However, by the same token, since the field was relatively new, one would have expected petitioners to have exhibited more caution when making such substantial investments. Indeed, Guzman signed a $130,000 promissory note when her net worth was $21,000 and her annual gross income was about $20,000. Accordingly, while we believe that petitioners sincerely hoped to spread the gospel and to further the beliefs of JLM through the marketing of the tapes, we find that they did not possess the actual and honest profit motive required under section 162, or section 212. In fact we do not believe any of petitioners were really concerned about making a profit. They were concerned about obtaining cash tax refunds to support either the ministry or their own personal interests.

As a result of our finding that petitioners lacked an actual and honest profit motive, under section 183 all deductions taken in connection with petitioners' investment in the tapes are disallowed except to the extent that gross income exceeds the deductions allowable. Section 183(a) and (b). We will examine each of these deductions separately.

At the trial of this case we heard evidence from respondent's witness, Mosesson, that the tapes had zero value. DanKryst set the purchase price for each of the tapes at $100,000. This figure included DanKryst's purchase price of

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$95,000 plus a $5,000 overhead charge. Petitioners presented no evidence as to the value of the tapes other than their "Production Costs Summary Reports" which we find to be of little value.22/ They sought no appraisals of the tapes and they did not negotiate the $100,000 purchase price per tape. They presented no expert testimony as to the value of the tapes. Petitioners did however present evidence that from 1981 to 1983 only $2,624.43 was earned by SWEET from the sale and rental of the tapes to individuals not involved in the promotion of the investment program.

Upon viewing the tapes one quickly realizes that it is unrealistic to value them at $100,000. The tapes are of "amateurish" quality. The vocal quality is often shallow and the movement from scene to scene is very disruptive. The artists featured are not well-known persons, e.g., Thompson, and would have limited appeal. Each tape begins with a listing of credits including the producers or purchasers of the tape, and the title of the tape. Then the artist begins to discuss the featured topic using various visual aides. The tapes are of a fundamental religious nature as evidenced by one scene where Thompson while speaking asks his listeners to "shout Amen." While the tapes do have some appeal as indicated by the $2,624.43 earned from 1981

22/ We think these reports were not prepared in conjunction with the production of the tapes but were prepared in anticipation of trial. We are not convinced that the items listed were the actual costs incurred.

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to 1983, we think this appeal is somewhat limited due to the quality and content of the tapes, and the artists involved.23/ We therefore find that the tapes have de minimis value.

In addition to his argument that the tapes have zero value, respondent argues that the notes executed by petitioners, which on their face appeared to be full recourse promissory notes, were in reality nonrecourse notes. We agree. We are not convinced that any of the parties expected the notes to be paid in full or that any action would have been taken to collect on the notes if they were not paid in full. We are influenced in reaching our decision by the actions of the parties in regard to the "recourse notes." When petitioners purchased their tapes they kept the promissory notes. Gary let petitioners keep the notes because he had been so advised by Williams. Of course this would prevent the notes from falling into the hands of third parties who might have tried to collect on them. When the IRS began investigating the video program, Gary asked petitioners to give him the notes. He realized at that point the significance in allowing petitioners to retain the notes. Without possession of a note, a person claiming ownership is not a "holder" and has none

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23/ We do not, however, agree with respondent's expert witness, Gloria R. Mosesson, that the tapes had a zero value. Mosesson's opinion that the tapes had a zero value is belied by the fact that some of them were leased or sold. We do not believe Mosesson was too well qualified to determine what would appeal to people with religious bents living in the mountains and countryside of Arkansas and the surrounding area.

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of the rights of a holder. Haupt v. Coldwell, 500 S.W. 2d 563 (Tex. Civ. App. 1973). Without the face value of the notes, the basis for all the tax deductions would fall.

As further evidence that the notes were nonrecourse in nature, the purportedly recourse nature of the notes was not honored by the parties. When questioned as to what recourse he had if the investors failed to repay the notes, Gary replied that he could: 1) repossess the tapes; 2) sue to collect on the notes, or 3) refinance the notes. However, the only option he had ever exercised was to repossess tapes from several investors who wanted to be released from their agreement when a split within JLM occurred. He had made no attempt to enforce any of the notes and would personally have difficulty doing that due to his relationship with the investors.

Accordingly, based upon the above factors, we find that petitioners had no personal liability[24/] for the notes. In substance, as revealed by the parties' actions, the notes were in

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24/ Because we have held that the notes were nonrecourse and lacking in economic substance, we agree with respondent that petitioners were not at risk pursuant to section 465, with respect to their investments. Porreca v. Commissioner, 86 T.C. ___ (April 28, 1986); Waddell v. Commissioner, 86 T.C. ___ (April 28, 1986). Without the notes, the only amounts at risk for petitioners were their nominal cash payments of amounts from $10 to $100.

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reality nonrecourse notes. Moreover, the excessive debt evidenced by the notes and the excessive price charged for the tapes compared with the actual value of the tapes demonstrates clearly that the notes lacked economic substance. The notes therefore do not represent genuine indebtedness. See, e.g., Hagler v. Commissioner, 86 T.C. 598 (1986); Fuchs v. Commissioner, 83 T.C. 79, 102 (1984); Brannen v. Commissioner, 78 T.C. 471, 493 (1982), affd. 722 F.2d 695 (11th Cir. 1984).

Interest deductions

Section 163(a) allows a deduction for all interest paid or accrued within the taxable year on indebtedness. We have held that the notes herein do not constitute genuine indebtedness because they lack economic substance. Therefore, the requirement of section 163 that interest must be paid or accrued on indebtedness is not met. See Knetsch v. United States, 364 U.S. 361 (1960); Narver v. Commissioner, 75 T.C. 53 (1980), affd. per curiam 670 F.2d 855 (1982); Flowers v. Commissioner, supra at 942. Accordingly, petitioners' deductions for interest are disallowed.

Depreciation deductions

Section 167 allows as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business, or held for the production of income.

Section 183(b) provides that if an activity is not engaged in for profit there shall be allowed:

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> (1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and
>
> (2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

In order to qualify for a deduction, the depreciation expenses must be associated with an "actual and honest objective of making a profit." Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); Dean v. Commissioner, 83 T.C. 56 (1984); Lemmen v. Commissioner, 77 T.C. 1326, 1340 (1981). In addition, pursuant to section 183(b)(2), depreciation deductions are only allowed to the extent of the gross income from the investment activity. Section 1.183-1(b)(1)(iii), Income Tax Regs.

We have held that petitioners lacked an actual and honest objective of making a profit. Moreover, petitioners reported only losses from their investment in the tapes. We therefore hold that under section 183(b) no depreciation deductions are allowable. See Elliott v. Commissioner, 84 T.C. 227, 243 (1985),

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affd. 782 F.2d 1027 (3d Cir. 1986).25/

Investment tax credits

Petitioners claimed investment tax credits for the tapes pursuant to section 38. Section 38(a) provides for an investment tax credit with respect to "section 38 property," defined in section 48(a)(1) as follows:

> (a) Section 38 property. --
>
> (1) In general.--Except as provided in this subsection, the term "section 38 property" means--
>
> (A) tangible personal property ***.
>
> Such term includes only recovery property *** with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 3 years or more. ***

Depreciation is allowable with respect to property used in a trade or business or held for the production of income. Section 167(a). We have disallowed petitioners' deductions for

25/ Moreover, due to our finding that the promissory notes were nonrecourse notes, petitioners would have had very little basis for purposes of depreciation. Depreciation deductions are not predicated on legal title but rather on one's actual investment in property. Mayerson v. Commissioner, 47 T.C. 340, 350 (1966). If the purchase price and the principal amount of a nonrecourse note unreasonably exceed the value of the property acquired, the note does not represent "genuine indebtedness," or an actual investment in property and is therefore not included in one's basis. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975); Odend'hal v. Commissioner, 80 T.C. 588, 604 (1983) affd. on this issue 748 F.2d 908 (4th Cir. 1984). Aside from the notes executed by petitioners, the only other cost to petitioners, and hence source of basis, was the nominal cash payments made by petitioners.

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depreciation because they lacked an actual and honest objective of making a profit. Accordingly, pursuant to section 48(a)(1) we must disallow the investment tax credits claimed as well.26/

Charitable contribution

Respondent disallowed petitioner Guzman's charitable contribution deduction of $2,707.80. Petitioner bears the burden of proof in regard to this deduction. Welch v. Helvering, 290 U.S. 111, 115 (1933); Rule 142(a). Guzman has offered no evidence to substantiate this deduction. We therefore find that petitioner has failed to carry her burden of proof. Accordingly, we sustain respondent's determination.

Additions to Tax

Respondent determined additions to tax against petitioners pursuant to section 6659(a), section 6621(d), and section 6653(a).

26/ We also think respondent's arguments that the tapes were not in use in 1980 and that no payments of interest were made in 1980 merit consideration. The evidence suggests that the JLM program did not get underway until December of 1980. While there are stipulated into evidence numerous contracts between JLM and DanKryst for the sale of various tapes, all dated December 3, 1980, it is also stipulated that Don Lyon, Inc., the predecessor of DanKryst, did not change its name to DanKryst, Inc. until July 13, 1981. There appears to have been little or no activity with regard to the tapes prior to February 1981.

We are also at a loss to understand what funds were used by petitioners to pay interest in 1980. The tapes did not produce any revenue in 1980 and petitioners' cash tax refunds were not available until after 1980. There is no evidence that petitioners made direct payments of interest to DanKryst in 1980.

Petitioners had the burden of proving these points, and failed to do so.

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Section 6659(a) provides for an addition to tax of up to 30 percent of the underpayment where there is a valuation overstatement of the value of property, or of its adjusted basis, of 150 percent or more. Section 6659(c). Petitioners' argument is simple. They state merely that they have not made any valuation overstatements. Respondent disagrees and we agree with respondent.

Petitioners have offered no evidence of the value of the tapes other than their self-serving assertions. No expert testimony was offered. No objective appraisals were entered into evidence. We have found that the value of the tapes was de minimis and that the promissory notes executed by petitioners did not represent genuine indebtedness. We have also held that petitioners' bases in the tapes was limited to their nominal cash payments of $10 to $100. Since petitioners included the promissory notes in their computations of basis they overvalued their basis by an amount in excess of 250 percent. Accordingly, respondent's determination of an addition to tax under section 6659(a) is sustained.

Section 6621(d) provides for the payment of interest on substantial underpayments attributable to tax motivated transactions. Section 6621(d) was enacted, among other reasons, "to put more teeth into section 6659." Neely v. Commissioner, 85 T.C. 934, 957 (1985). The legislative history of section 6621(d) indicates Congress' intent to stifle tax shelter promotions that

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exploit the deductibility of appreciation in capital gain assets. H. Rept. No. 98-861 (Conf. Rept.), 1984-3 C.B. (Vol. 2) 1, 252. The amount of interest payable under section 6621(d) is 120 percent of the amount established under section 6621(b), and is applicable with respect to interest accruing after December 31, 1984, even though the transaction was entered into prior to the date of the enactment of section 6621(d). Solowiejczyk v. Commissioner, 85 T.C. 552 (1985). A substantial underpayment is defined as "any underpayment of taxes *** which is attributable to 1 or more tax motivated transactions if the amount of the underpayment for such year so attributable exceeds $1,000." A tax motivated transaction includes any valuation overstatement under section 6659(c). Section 6621(d)(3)(A)(i); See, e.g., Snyder v. Commissioner, 86 T.C. 567 (1986); Parker v. Commissioner, 86 T.C. 547 (1986). We have held that petitioners are liable under section 6659(a) for valuation overstatements. We therefore find that petitioners' substantial underpayments were due to tax motivated transactions. Accordingly, respondent's determination of an addition to tax under section 6621(d) is sustained.

Section 6653(a) provides for an addition to tax of five percent of the underpayment if any part of the underpayment is due to negligence or intentional disregard of rules and regulations. For purposes of section 6653(a), negligence has been described as a "lack of due care or failure to do what a

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reasonable and ordinarily prudent person would do under the circumstances." Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967). Petitioners have the burden of proof on this issue. Bixby v. Commissioner, 58 T.C. 757, 791-792 (1972); Enoch v. Commissioner, 57 T.C. 781, 802-803 (1972). Petitioners contend that JLM representatives sought advice from the IRS concerning the tax treatment of MVR. The JLM representatives met with individuals from the IRS and left this meeting with the belief that their MVR qualified for investment tax credits. They did not however present specific details of their tax shelter plan and the IRS refused to give them written approval of the plan. Petitioners relied on the advice of the JLM representatives that the MVR qualified for the credits and deductions taken. However, petitioners did not seek advice from individuals independent of JLM. Petitioners expressed trust in Davis, Chester, and other JLM representatives. None of them ever viewed their tapes, or sought an independent appraisal to determine whether they were actually worth $100,000. Petitioners' actions in purchasing the tapes are not what one would expect from a reasonable and ordinarily prudent person. We therefore find that petitioners have failed to overcome respondent's determination of an addition to tax under section 6653(a).

To reflect the foregoing,

Decisions will be entered for respondent.

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APPENDIX A

Docket Nos.	Tax Years	Deficiency	Additions to Tax §6653(a)	§6659	Residence When Petition Filed
Robert L. & Leona M. Chester:					
14299-84	1977	$5,007.38	-	-	Zephyrhills, Florida
	1978	1,919.11	-	-	
	1979	5,502.50	-	-	
	1980	1,493.00	-	-	
	1981	4,962.00	-	$1,488.60	
	1982	7,430.00	-	2,229.00	
Nolen E. & Nadine C. Sherritze:					
14324-84	1977	$2,221.00	-	-	Tampa, Florida
	1978	5,224.00	-	-	
	1979	3,219.00	-	-	
	1980	151.00	-	-	
	1981	2,149.00	-	644.70[1]	
	1982	2,503.00[2]	-	750.90[3]	
Doris M. Guzman:					
14325-84	1977	$5,052.95	-	-	Winnsboro, Louisiana
	1978	5,857.04	-	-	
	1979	3,090.01	-	-	
	1980	2,456.00	-	-	

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1 This addition to tax was asserted in respondent's Second Amendment to Answer.

2 In his answer respondent asserted an increased deficiency of $385 pursuant to section 6214(a).

3 This addition to tax was asserted in respondent's Second Amendment to Answer.

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Billy J. & Thelma Ledford:					
14328-84	1977	$5,120.00	-	-	Millington, Tennessee
	1978	1,921.00	-	-	
	1979	5,959.00	-	-	
	1980	6,401.50	-	-	
Donald E. & Virginia M. Kifer:					
14329-84	1977	$ 3,759.00	-	-	Belleville, Illinois
	1978	3,123.00	-	-	
	1979	4,344.00	-	-	
	1980	10,039.00	-	-	
William D. & Dawn R. Moore:					
15227-84	1979	$1,038.00	$ 51.90	-	North Little Rock, Arkansas
	1980	3,051.00	152.55	-	
Theresa G. DeGraaf:					
15228-84	1977	$1,084.00	$ 54.00	-	Hardy, Arkansas
	1978	416.00	21.00	-	
	1980	517.00	26.00	-	
Daniel R. & Martha L. Chester:					
15240-84	1977	$4,354.92	-	-	Cherokee Village, Arkansas
	1978	500.88	-	-	
	1979	4,101.20	-	-	
	1980	1,040.00	-	-	
Gene R. & Dorothy J. Vaughn:					
15915-84	1979	$ 233.93	$ 11.70	-	Hardy, Arkansas
	1980	923.00	46.15	-	
James W. & Charlotte Strader:					
15916-84	1980	$ 330.00	$ 17.00	-	Hardy, Arkansas

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Carl A. & Rochelle A. Culpepper:					
15932-84	1978	$ 325.00	$ 16.25	-	North Little Rock,
	1979	1,482.00	74.10	-	Arkansas
	1980	1,157.00	57.85	-	
Grider & Sally Thrasher:					
15933-84	1977	$1,080.00	-	-	Broken Arrow,
	1978	2,051.00	-	-	Oklahoma
	1979	469.00	-	-	
	1980	887.00	-	-	
Joe D. & Carol L. Kuykendall:					
20675-84	1977	$4,419.00	$220.95	-	Sherwood,
	1978	3,826.00	191.30	-	Arkansas
	1979	4,347.00	217.35	-	
	1980	5,041.00	252.05	-	
Billy O. & Dianne Urfer:					
22153-84	1978	$ 725.00	-	-	Heber Springs,
	1979	761.00	-	-	Arkansas
	1980	270.00	-	-	
Renita L. Johnston:					
22336-84	1977	$ 512.00	$ 26.00	-	Lincoln,
	1978	597.00	30.00	-	Nebraska
	1979	801.00	40.00	-	
	1980	953.00	48.00	-	

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APPENDIX B

FULL RECOURSE

PROMISSORY NOTE

$_____

FOR VALUE RECEIVED this _____ day of _____, 19___, _____, (Maker), promises to pay to the order of _____, (Payee), the principal sum of _____ DOLLARS ($_____), with interest at the rate of eight percent (8%) per annum, payable in full seven (7) years from the date hereof as herein provided.

Principal and interest shall be payable in lawful money of the United States of America, at such place as the Payee may designate in writing.

There shall be no penalty for prepayment of all or part of the principal of this Note.

This Full Recourse Note is made and delivered in accordance with that Purchase Agreement of even date thereof, the terms of which are by this reference incorporated herein.

DUE DATE: $_____, or the unpaid balance thereof, shall be due on or before the _____ day of _____, 19___.

SIGNED:

_____
Maker

_____
Maker

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APPENDIX C

The following tables list the deductions, credits, and losses taken by each petitioner in connection with their MVR investment:

Year	Income	Depreciation	Interest	Total Deductions	Investment Tax Credit	Losses
Robert L. & Leona M. Chester - #14299-84						
1980	-0-	8,929.00	-0-	8,929.00	12,500.00	8.929.00
1981	4,933.60	19,345.16	4,934.65	24,279.81	-0-	19,346.21
1982	14,803.65	19,345.16	13,922.45	33,267.61	-0-	18,463.96
Total	19,737.25	47,619.32	18,857.10	66,476.42	12,500.00	46,639.17
Nolen E. & Nadine C. Sherritze - #14324-84						
1980	-0-	2,738.09	-0-	2,738.09	11,500.00	4,677.73
1981	4,539.69	18,710.31	4,540.64	23,250.95	-0-	18,711.26
1982	13,619.34	16,428.57	12,987.51	29,416.08	-0-	15,796.74
Total	18,159.03	37,876.97	13,438.15	51,315.02	11,500.00	39,185.73
Doris M. Guzman - #14325-84						
1980	-0-	10,000.00	-0-	10,000.00	14,000.00	10,000.00
1981	5,521.20	21,666.66	5,522.37	27,189.03	-0-	21,667.25
1982	16,580.10	21,666.66	15,318.36	36,985.02	-0-	20,404.92
Total	22,101.10	53,333.32	20,840.73	74,174.05	14,000.00	52,072.17

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Billy J. & Thelma Ledford - #14328-84

1980	-0-	27,857.07	-0-	27,875.07	13,000.00	27,857.07
1981	15,395.80	29,172.01	5,128.37	34,300.38	-0-	29,670.55
1982	4,629.83	14,594.18	13,906.32	28,500.50	-0-	13,104.70
1983	16,327.44	14,594.18	9,141.17	23,735.35	-0-	7,407.91
Total	36,353.07	86,217.44	28,157.86	114,393.30	13,000.00	70,632.32

Donald E. & Virginia M. Kifer - #14329-84

1980	-0-	37,142.84	-0-	37,142.84	13,000.00	37,142.84
1981	5,133.78	26,530.60	5,134.86	31,665.46	-0-	26,531.68
1982	15,395.79	13,265.31	14,333.02	27,598.33	-0-	12,202.54
Total	20,529.57	76,938.75	19,467.88	96,406.63	13,000.00	75,877.06

William D. & Dawn R. Moore - #15227-84

1980	-0-	7,142.84	-0-	7,142.84	2,500.00	7,142.84
1981	988.00	5,102.00	988.00	6,090.00	-0-	5,102.00
1982	2,961.00	3,644.00	2,789.00	6,433.00	-0-	3,472.00
Total	3,949.00	15,888.84	3,777.00	19,665.84	2,500.00	15,716.84

Theresa G. DeGraaf - #15228-84

1980	-0-	4,285.70	-0-	4,285.70	1,500.00	4,285.70
1981	594.12	1,785.71	594.24	2,379.95	-0-	1,785.83
1982	1,776.41	1,785.71	1,606.00	3,391.71	-0-	1,615.30
Total	2,370.53	7,857.12	2,200.24	10,057.36	1,500.00	7,686.83

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Daniel R. & Martha L. Chester - #15240-84

1980	-0-	12,857.10	-0-	12,857.10	9,000.00	12,857.10
1981	3,551.65	22,040.82	3,552.40	25,593.22	-0-	22,041.57
1982	10,658.63	11,020.42	10,085.45	21,105.87	-0-	10,447.24
1983	11,303.61	11,020.42	6,365.92	17,386.73	-0-	6,082.73
Total	25,513.89	56,938.76	20,003.77	76,942.92	9,000.00	51,428.64

Gene R. & Dorothy J. Vaughn - #15915-84

1980	-0-	2,857.00	-0-	2,857.00	1,000.00	2,857.00
1981	393.98	2,040.84	393.98	2,434.82	-0-	2,040.84
1982	1,184.29	1,020.43	1,118.49	2,138.92	-0-	954.63
Total	1,578.27	5,918.27	1,512.47	7,430.74	1,000.00	10,750.31

James W. & Charlotte Strader - #15916-84

1980	-0-	4,285.68	-0-	4,285.68	3,000.00	4,285.68
1981	1,181.72	4,285.72	1,181.97	5,467.69	-0-	4,285.97
1982	3,553.00	4,286.00	3,282.00	7,568.00	-0-	4,015.00
Total	4,734.72	12,857.40	4,463.97	17,321.12	3,000.00	12,586.65

Carl A. & Rochelle A. Culpepper - #15932-84

1980	-0-	5,714.28	-0-	5,714.28	2,000.00	5,714.28
1981	788.00	4,082.00	788.00	4,870.00	-0-	4,082.00
1982	2,368.58	2,040.00	2,232.49	4,272.49	-0-	1,903.91
Total	3,156.58	11,836.28	3,020.49	14,856.77	2,000.00	11,700.19

Grider & Sally Thrasher - #15933-84

1980	-0-	-0-	-0-	-0-	4,500.00	-0-
1981	1,776.19	12,856.50	1,776.19	14,632.69	-0-	12,856.50
1982	5,329.30	9,183.85	4,841.90	14,025.75	-0-	8,696.45
Total	7,105.49	22,040.35	6,618.09	28,658.44	4,500.00	21,552.95

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Joe D. & Carol L. Kuykendall - #20675-84

1980	-0-	24,762.00	-0-	24,762.00	13,000.00	24,762.00
1981	5,127.00	30,069.00	5,128.00	35,197.00	-0-	30,070.00
1982	15,395.80	15,033.80	13,993.05	29,026.85	-0-	14,172.62
Total	20,522.80	69,864.80	19,121.05	88,985.85	13,000.00	69,004.62

Billy O. & Dianne Urfer - #22153-84

1980	-0-	2,148.00	-0-	2,148.00	1,500.00	2,143.00
1981	594.00	3,675.00	594.00	4,269.00	-0-	3,675.00
1982	1,776.00	2,623.00	1,627.00	4,250.00	-0-	2,474.00
Total	2,370.00	8,446.00	2,201.00	10,667.00	1,500.00	8,292.00

Renita L. Johnston - #22336-84

1980	-0-	5,714.28	-0-	5,714.28	2,000.00	5,714.28
1981	788.00	4,082.00	788.00	4,870.00	-0-	4,082.00
1982	2,369.00	1,458.00	2,232.00	3,690.00	-0-	1,321.00
Total	3,157.00	11,254.28	3,020.00	14,274.28	2,000.00	11,117.28

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T. C. Memo. 1986-356

UNITED STATES TAX COURT

ROBERT SATIACUM and SUSIE SATIACUM, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

ROBERT SATIACUM, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 469-77, 16540-80. Filed August 6, 1986.

Ramon M. Escure and John J. O'Connell, for the petitioners.

Thomas N. Tomashek, for the respondent.

MEMORANDUM OPINION

WILBUR, Judge: In these consolidated cases respondent determined the following Federal income tax deficiencies and additions to tax:

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ORIGINAL

DOCKET NO. 469-77

ROBERT SATIACUM

Year	Deficiency	Additions to Tax Section 6651(a)[1]	Section 6653(a)
1971	$145,515	$ 36,379	$ 7,276
1972	439,583	109,896	21,979
1973	516,250	129,063	25,813
1974	761,054	190,264	38,053

SUSIE SATIACUM

1971	$ 64,711	$ 16,178	$ 3,236
1972	211,587	52,897	10,579
1973	249,825	62,456	12,491
1974	372,139	93,035	18,607

DOCKET NO. 16540-80

ROBERT SATIACUM

1975	$393,411	$ 98,353	$19,671
1976	361,453	90,363	18,073

In a supplemental stipulation of facts filed July 12, 1985, the parties agreed that petitioners are not liable for the additions to tax under sections 6651(a) and 6653(a).

After concessions, the only issue for decision is whether income earned from the retail sale of cigarettes and other tobacco products and from a commercial fishing operation conducted by an enrolled member of the Puyallup Indian Tribe is subject to Federal income taxation.

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1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect for the years in issue.

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These cases were submitted under Rule 122.[2] The stipulation of facts is incorporated herein by this reference. The pertinent facts are summarized below.

Robert Satiacum and Susie Satiacum (petitioners) resided in Tacoma, Washington at the time their petitions were filed in these cases. Robert Satiacum (petitioner) is an enrolled member of the Puyallup Indian Tribe.

During the years 1971 through 1976, petitioner operated a retail tobacco store (smokeshop) selling cigarettes and other miscellaneous products. The net profits from the cigarette and tobacco sales were as follows:

Year	Net Profit
1971	$ 35,000
1972	95,000
1973	110,000
1974	150,000
1975	300,000
1976	330,000

The land upon which the smokeshop was situated was acquired by petitioner's father and has been held in trust by the United States. Petitioner is a "noncompetent Indian" in that he cannot alienate or encumber the land without the consent of the Secretary of the Interior. See Stevens v. Commissioner, 452 F.2d 741, 742 n. 1 (9th Cir. 1971), affg. in part and revg. in part 52 T.C. 330 (1969), supplemental opinion 54 T.C. 351 (1970). In

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[2] All Rule references are to the Tax Court Rules of Practice and Procedure.

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addition, petitioner had a net profit from the sale of fish in 1974. The fishing income was derived from the operation of a commercial fishing business at various locations on Puget Sound.

For the years 1971 through 1976, petitioners did not file Federal income tax returns. In the notices of deficiency, respondent determined that the net earnings from the smokeshop and the commercial fishing operation are includable in petitioners' gross income. They do not contest the correctness of the amounts of income determined by respondent in the notices of deficiency for the years 1971 through 1976. They argue, however, that such income is exempt from Federal income taxation.

Section 61 provides that income "from whatever source derived" is subject to Federal income taxation. It is now well settled that the income of American Indians falls within the ambit of section 61. An exception to this general rule is made if a taxpayer can identify express exemptive language in a statute or treaty providing that these amounts are not required to be included in gross income. Dillon v. United States, 792 F.2d 849 (9th Cir. 1986), affg.____F. Supp.____, (W.D. Wash. 1985, 85-1 USTC par. 9150, 55 AFTR2d 85-705), affg. Cross v. Commissioner, 83 T.C. 561 (1984) (Court reviewed), affg. Hargrove v. Commissioner, T.C. Memo. 1985-113, affg. Gord v. Commissioner, T.C. Memo. 1984-517; United States v. Anderson, 625 F.2d 910, 913 (9th Cir. 1980); Commissioner v. Walker, 326 F.2d 261, 263 (9th Cir. 1964), affg. in part and revg. in part 37 T.C. 962 (1962);

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Karmun v. Commissioner, 82 T.C. 201, 204 (1984); Hoptowit v. Commissioner, 78 T.C. 137 (1982), affd. 709 F.2d 564 (9th Cir. 1983); Jourdain v. Commissioner, 71 T.C. 980 (1979), affd. 617 F.2d 507 (8th Cir. 1980). Petitioner's status as an Indian is not alone sufficient to insulate him from liability for the payment of Federal income tax. Superintendent Five C. Tribes v. Commissioner, 295 U.S. 418 (1935); Choteau v. Burnet, 283 U.S. 691 (1931). Petitioners have been unable to identify an express exemptive provision in any Treaty or Act of Congress. Thus, we sustain respondent's determination that the income from the smokeshop and the commercial fishing business is taxable under section 61.

Petitioners contend that the Medicine Creek Treaty of 1854, 10 Stat. 1132, is the definitive document regulating relations between the United States and the Puyallup Indian Tribe. In a recent Court reviewed opinion, we considered this treaty in its historical context and we concluded that no express or implied provision exists to exempt petitioners' smokeshop and fishing income from taxation. Cross v. Commissioner, 83 T.C. 561 (1984), affd. Dillon v. United States, supra. See also Saunooke v. United States, 8 Cl. Ct. 327 (1985), on appeal (Fed. Cir., April 2, 1986).

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Petitioners further argue that their smokeshop income is exempt from taxation under the General Allotment Act of 1887, 24 Stat. 388, 25 U.S.C. sec. 331 et seq. (1982) (the Act).[3] Even if we assume that petitioners' trust land comes under the jurisdiction of that Act, no exemption from taxation would exist on these facts. The Supreme Court held that the Act exempts from taxation income from land held in trust if such income is "directly derived" from the land. Squire v. Capoeman, 351 U.S. 1 (1956). The numerous courts that have held income exempt under the Act have done so only in factual situations where the land itself was being exploited.[4] The Ninth Circuit, in affirming an opinion of this Court, recently held that income from a smokeshop located on trust property is not directly derived from the land and is therefore fully subject to Federal taxation. Dillon v.

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The General Allotment Act of 1887, 24 Stat. 388, 25 U.S.C. sec. 331 et seq. (1982), provides that the United States is to hold, in trust, title to lands allotted to Indians under various treaties until such time as the Secretary of the Interior determines that the allottees are competent to hold fee simple title to their allotted lands. This trusteeship has been periodically extended by various Executive Orders and was finally extended indefinitely by the Indian Reorganization Act of 1934, 48 Stat. 984, 25 U.S.C. sec. 462 (1982).

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Squire v. Capoeman, 351 U.S. 1 (1956) (Timber sales proceeds exempt from capital gains tax); Stevens v. Commissioner, 452 F.2d 741 (9th Cir. 1971), affg. in part and revg. in part 52 T.C. 330 (1969), supplemental opinion 54 T.C. 351 (1970) (Income from farming and ranching is tax exempt); United States v. Daney, 370 F.2d 791 (10th Cir. 1966) (Income from oil and gas leases is tax exempt); Hayes Big Eagle v. United States, 156 Ct. Cl. 665, 300 F.2d 765 (1962) (Royalties from mineral deposits are tax exempt).

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United States, supra.[5] For the reasons expressed in that opinion, we reach the same conclusion in the instant cases.[6]

Petitioners argue that the income produced by their commercial fishing business should also be tax exempt. This issue was decided adversely to petitioners by this Court in Earl v. Commissioner, 78 T.C. 1014 (1982). In Earl, the taxpayer, a Puyallup Indian, worked as a crew member on a commercial fishing vessel. He argued that the income he received in his capacity as a crew member was exempt from Federal taxation under Article Three of the Medicine Creek Treaty of 1854, 10 Stat. 1132. Article Three states that the right to fish in the usual and accustomed areas is secured to the Puyallup Indians in common with all other citizens of that region. That provision has been interpreted to mean that Indians would be entitled to share the

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See Critzer v. United States, 220 Ct. Cl. 43, 597 F.2d 708 (1979); Wilbur v. Commissioner, T.C. Memo. 1984-576; Landry v. Commissioner, T. C. Memo. 1984-575; Estate of Davis v. Commissioner, T.C. Memo. 1984-574; Swiger v. Commissioner, T.C. Memo. 1984-228; Comenout v. Commissioner, T.C. Memo. 1982-40; Hale v. United States, 579 F. Supp. 646 (E.D. Wash. 1984).

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Petitioners argue alternatively that the portion of the smokeshop income allocable to the fair rental value of the unimproved land upon which the smokeshop is located should be exempt as income directly derived from the land. This argument has been thoroughly considered and rejected by the Ninth Circuit on similar facts. Dillon v. United States, 792 F.2d 849, 86-2 USTC 9492 (9th Cir. 1986), affg. ___ F. Supp. ___, (W.D. Wash. 1985, 85-1 USTC par. 9150, 55 AFTR2d 85-705), affg. Cross v. Commissioner, 83 T.C. 561 (1984) (Court reviewed), affg. Hargrove v. Commissioner, T.C. Memo. 1985-113, affg. Gord v. Commissioner, T.C. Memo. 1984-517; see also Hale v. United States, supra.

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fish caught equally with other residents. United States v. State of Washington, 384 F. Supp. 312 (W.D. Wash. 1974), affd. 520 F.2d 676 (9th Cir. 1975). Article Three, however, does not contain any language dealing with the Federal taxation of fishing income and no such exemption can arise by implication. Mescalero Apache Tribe v. Jones, 411 U.S. 145, 156 (1973); Fry v. United States, 557 F.2d 646, 649 (9th Cir. 1977); Jourdain v. Commissioner, 71 T.C. 980, 990 (1979), affd. 617 F.2d 507 (8th Cir. 1980).

As previously indicated, the Supreme Court held that income directly derived from land allotted to an Indian under the General Allotment Act of 1887, 24 Stat. 388, 25 U.S.C. sec. 331 et seq. (1982), is exempt from Federal income taxation. Squire v. Capoeman, supra. But the reasoning in Squire has no application to the facts of the instant cases because petitioner "has no individual fishing rights analogous to an allotment under the General Allotment Act of 1887." Earl v. Commissioner, supra at 1019 (citations omitted).[7] According to this Court's interpretation of the Medicine Creek Treaty of 1854, 10 Stat. 1132:

> [Taxpayer's] fishing rights under the treaty as a member of the Puyallup Tribe are more comparable to his rights as a member of the tribe in unallotted land on the reservation than to

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7 See United States v. Anderson, 625 F.2d 910 (9th Cir. 1980) (Income derived by noncompetent Indian from cattle ranching under tribal licenses covering land held in trust by the United States for other noncompetent Indians was taxable); Fry v. United States, 557 F.2d 646 (9th Cir. 1977) (Noncompetent Indian engaged in logging on tribal lands as a subcontractor to a non-Indian company was taxable on the income realized).

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individual rights in allotted land. Similarly, [taxpayer's] income from the exercise of the tribe's communal fishing rights would be more analogous to income obtained from unallotted tribal land and not to income derived from allotted land, which was involved in Squire v. Capoeman * * * [78 T.C. at 1019.]

We conclude that, regardless of whether petitioners were exercising their tribal rights while engaging in their commercial fishing operation, their income is taxable.

To reflect concessions and our conclusions with respect to the disputed matters,

Decisions will be entered under Rule 155.

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JU 11.7/2: 1986-357
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T. C. Memo. 1986-357

UNITED STATES TAX COURT

HERBERT B. MOSKOVITZ and MARY MOSKOVITZ, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

MARY SALOMONE, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 31406-81, 31407-81. Filed August 6, 1986.

Phyllis Horn and J. Earl Epstein, for the petitioners.

Lynn L. Casimir, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILBUR, Judge: Respondent determined deficiencies in petitioners' Federal income tax and additions to tax under section 6653(a)[1] as follows:

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[1] Unless otherwise indicated, all section references are to the (footnote continued)

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Docket No.	Year	Deficiency	Additions to tax under sec. 6653(a)
31407-81	1973	$7,738	$387.00
31406-81	1974	8,251	412.56
	1975	6,871	344.00

The issues for decision are:

(1) Whether respondent's determination of omitted gross income in the amounts of $21,501, $23,060 and $20,288 for the taxable years 1973, 1974, and 1975, respectively, is correct;

(2) Whether respondent is barred by the normal 3-year statute of limitations from assessing and collecting the deficiencies in income tax due or the additions to tax for the taxable years 1973, 1974, or 1975;

(3) Whether petitioner Mr. Moskovitz is an innocent spouse within the meaning of section 6013(e); and

(4) Whether any part of petitioner Mary Salomone's underpayment of income tax liability for 1973, and petitioners' underpayment of income tax liabilities for 1974 and 1975 was due to negligence or intentional disregard of rules and regulations.

Petitioners, Herbert Moskovitz (hereinafter "Mr. Moskovitz") and Mary Moskovitz (hereinafter "petitioner") were married on November 30, 1974. Petitioner-wife's maiden name was Salomone. At the time they filed the petitions in these cases, petitioners were residents of Cornwells Heights, Pennsylvania.

(footnote continued from previous page)
Internal Revenue Code of 1954, as amended, during the years in issue.

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Petitioner filed a timely income tax return for her 1973 taxable year. Petitioners filed timely joint Federal income tax returns for their 1974 and 1975 taxable years.

On December 3, 1981, respondent mailed a notice of deficiency to petitioner for her 1973 taxable year showing the deficiency and additions to tax set forth above. On the same date, respondent mailed a notice of deficiency to petitioners for their 1974 and 1975 taxable years showing the deficiencies and additions to tax noted above. The amount of gross income reported on petitioner's 1973 return is $11,175.81. The amount of gross income stated on petitioners' 1974 and 1975 joint Federal income tax returns is $20,608 and $21,004, respectively.

On September 15, 1979, and June 15, 1980, petitioner executed Forms 872 consenting to extensions of the statute of limitations with regard to her 1973 return to December 31, 1980, and December 31, 1981, respectively. In each instance, her consent was expressly conditioned on the applicability of the 6-year statute under section 6501(e)(1). On June 15, 1980, petitioners executed a Form 872 consenting to a similar extension with regard to their 1974 joint return to December 31, 1981. This consent was also expressly conditioned on the applicability of section 6501(e)(1). On March 12, 1979, September 15, 1979, and June 15, 1980, petitioners executed Forms 872 consenting to extensions with regard to their 1975 joint return to December 31,

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1979, December 31, 1980, and December 31, 1981, respectively. The consents regarding the 1975 return, however, were not made expressly conditional on the applicability of section 6501(e)(1).

From January 1971 through July 1975, petitioner was employed by Mr. Robert P. Levy and DRT Industries, Inc. (hereafter "DRT") of Philadelphia, Pennsylvania as Mr. Levy's personal secretary and bookkeeper. Pursuant to this employment, Mr. Levy gave petitioner a power of attorney with respect to a checking account of his, hereafter referred to as "the special account."

Petitioner left her employment with Mr. Levy and DRT, at the end of July 1975, because she was pregnant. Janet Szlachta, another of Mr. Levy's employees, took over the duty of maintaining the special account on August 1, 1975. She noticed some irregularities in the records of that account and determined that it would not balance. Mr. Levy advised Ms. Szlachta to contact his accountant, Mr. Martin Goldberg, for assistance in reconciling the special account.

Mr. Goldberg's initial audit of the special account took place in August 1975. He reviewed the transactions in that account for the 4 months preceding petitioner's leaving Mr. Levy's employ and prepared a list of discrepancies found in the account's records for that period. The discrepancies consisted of unrecorded deposits and cleared and returned checks not in agreement with the notations on the corresponding check stubs from which they had been detached. For the period of June 13,

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1975 through July 17, 1975 (the latter being the cutoff date for the last bank statement issued prior to petitioner's departure), Mr. Goldberg found the following discrepancies:

(a) 3 unrecorded deposits totaling $6,727.

(b) check no. 513: stub read $15, check cleared for $1,500 to cash.

(c) check No. 520: stub read "void," check cleared for $200.

(d) check No. 547: stub read $15, check cleared for $1,500 to cash.

(e) check No. 567: stub read $100 to cash, check cleared for $1,000 to cash.

Using the corrected balance at the beginning of this period (i.e., the balance as of June 13, 1975) shown by the bank on its statements and using the figures recorded by petitioner on the stubs of checks drawn during this period, Mr. Goldberg arrived at a closing balance for the period of $1,982.

As of July 17, 1975, the bank statement showed a balance which, when adjusted for the outstanding checks and deposits in transit, came to $675. By taking into account the discrepancies found for the period, and using the corrected balance for the beginning of the period, Mr. Goldberg arrived at a closing balance of $675 as well. Petitioner herself had written $675 as the balance in the account on the stub for check number 593 which is dated July 31, 1975. Petitioner testified that she relied upon the bank statements rather than the check stubs to balance

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the account and that for this reason she often did not fill in the check stubs. The June-July bank statement however, was unopened when Janet Szlachta found it.

Mr. Goldberg looked for discrepancies in the other accounts handled by petitioner for Mr. Levy but he found none. Ms. Szlachta prepared the list of checks which form the basis for the deficiencies determined by respondent.

Petitioner prepared monthly bank reconciliations by listing checks in numerical order. She also reconciled the balance shown on the most recent bank statement received with the balance purportedly indicated on the checkbook stubs by adding deposits in transit and subtracting outstanding checks.

Mr. Levy occasionally asked petitioner to make purchases on his behalf, after which he would reimburse her by a check drawn on the special account, either directly or by paying the bill from the vendor. Petitioner would draw such checks for reimbursement herself. When making purchases on Mr. Levy's behalf, petitioner sometimes used her own charge accounts with a particular store or with her bank. Mr. Levy approved this procedure because it was sometimes easier for petitioner to make purchases in this way rather than to use a check from the special account, which had Mr. Levy's name on it, or to use one of Mr. Levy's own charge accounts.

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At the end of each month, petitioner paid Mr. Levy's bills. As bills came into Mr. Levy's office, she put them in a file that she kept for that purpose. When it came time to pay the bills, petitioner added the bills in the file to those that had been sent to Mr. Levy's home over the same 4-week period. She would then submit the bills to Mr. Levy who would check the bills, and have petitioner make out a check drawn on another account for an amount sufficient, once deposited into the special account, to pay the bills. In addition, Mr. Levy would tell petitioner to deposit enough money into the special account to allow occasional checks to be drawn payable to "cash" during the next month. Mr. Levy would determine the amount of the check on the basis of the prior balance in the special account. He learned the prior balance simply by asking petitioner what it was. Mr. Levy would sign the check, and petitioner would deposit it into the special account.

If Mr. Levy had asked petitioner to make any purchases on his behalf during the month, she would put the bills for these purchases in the file she kept for bills that were sent to Mr. Levy's office, and submit them to Mr. Levy at the end of the month as described above.

The understatement of $21,501.02 determined by respondent for the 1973 taxable year in petitioner's income was based on the sum of 90 different checks drawn on the special account during 1973. The understatement for 1974 consisted of respondent's

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inclusion in petitioners' taxable income for that year of $23,060, which was not reported on their return. This amount reflects the sum of 110 checks drawn on the same account during the 1974 taxable year. The understatement for 1975 is based on respondent's inclusion in petitioners' taxable income for that year of $20,288, which was not reported on their return. This amount consists of the sum of 57 checks drawn on the same account during the 1975 taxable year. All 257 of the checks referred to above were completed and signed by petitioner.[2]

What follows is a description of the circumstances surrounding the various checks that were included in the understatements during the years in issue.

In April of 1973, petitioner bought a baby set at the John Wanamaker store in Philadelphia (hereafter "Wanamaker's") for $32 which was charged to her own account at the store. The balance due on her charge account at the end of April 1973, which reflected various charges including the one for this baby set, was $60.50. In May 1973, a check for $60.50, number 10989, was

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[2] Exhibits 10-J, 11-K, and 12-L contain copies of the 257 checks upon which respondent based his deficiency determination for the 3 years in issue. We note that the total of the amounts shown on these checks ($21,582.49 for 1973; $23,352.55 for 1974; and $20,289.23 for 1975) differ slightly from the total understatements alleged by respondent as noted above. We leave the parties to make any appropriate adjustments as part of their Rule 155 computations.

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drawn on the special account payable to Wanamaker's. The corresponding checkbook stub was properly completed by petitioner.

In June of 1973, petitioner bought two games and two swimsuits at Wanamaker's. The cost of these items, $59.36 combined, was charged to her own account at the store. The balance due on petitioner's charge account at the end of June 1973, which reflected various charges including the ones noted above, was $126.99. In July 1973, a check for $126.99, number 11140, was drawn on the special account payable to Wanamaker's. The stub corresponding to this check was properly completed by petitioner.

In August 1973, petitioner bought a record (or some records) at Wanamaker's. She made this purchase by placing a charge for the cost ($2.86) on her own account at the store. The balance due on petitioner's Wanamaker charge account at the end of August 1973, which reflected various charges including the one for the record or records, was $45.86. In September 1973, a check for $45.86, number 11262, was drawn on the special account payable to Wanamaker's. The stub corresponding to this check was properly completed by petitioner.

In January 1974, petitioner bought a backgammon game and two puzzles at Wanamaker's. The cost of these items ($16.94) was charged to petitioner's own account at the store. The balance due on petitioner's charge account at the end of January 1974,

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which reflected various charges including the one for these items was $41.94. In February 1974, a check for $41.94, number 11581, was drawn on the special account payable to Wanamaker's. The stub corresponding to this check was properly completed by petitioner.

Mr. Levy gave petitioner some gifts during the time she was in his employ, including an engagement present and a wedding present. In April 1974, and in June of that year, she bought crystal (36 pieces in all) at Wanamaker's for $311.64 and $114.48, respectively. These amounts were charged to petitioner's own account at the store. The balance due on her Wanamaker's account at the end of April 1974 was $335.14; at the end of June 1974 the balance due was $351.35. In May 1974, a check for $335.14, number 11800, was drawn on the special account payable to Wanamaker's, and in July 1974, a check for $351.35, number 11936, was drawn on the special account payable to the same store. The stubs corresponding to these checks were properly completed by petitioner.

The total amount of all payments made on petitioner's charge account at Wanamaker's in 1973 is $852.15. This entire amount was paid by checks drawn by petitioner on the special account. These checks form part of the basis for the 1973 deficiency determined by respondent. The total of all payments made on petitioner's Wanamaker's charge account in 1974 is $1,794.68. Of this amount, $1,781.68 (all but $13) was paid by checks drawn by

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petitioner on the special account which form part of the basis for the 1974 deficiency. The total of all payments made on her charge account at Wanamaker's between January 1 and August 1, 1975 is $782.35. This entire amount was paid by checks drawn on the special account which form part of the basis for the 1975 deficiency.[3]

The following checks were drawn on the special account payable to a catalog company called The Horchow Collection:

Number	Date	Amount
11811	5/13/74	$ 99.60
11884	6/11/74	20.95
12101	9/13/74	110.80
12114	9/20/74	75.50
12119	9/27/74	241.70

The stubs that correspond to these checks were all properly completed by petitioner. In January of 1975, and in June of that year, she ordered additional items from The Horchow Collection. The orders were paid for by two checks, one for $28.20 and the other for $93.05, numbers 171 and 519 respectively, drawn on the special account payable to The Horchow Collection. The amounts of these checks were accurately recorded by petitioner on the stubs to which they correspond.

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3 Check number 183, for $51.08, was drawn by petitioner on the special account payable to Wanamaker's. This check forms part of the basis for the 1975 deficiency, but was not credited to petitioner's charge account at that store.

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The following checks were drawn on the special account payable to The Stitchery, a mail order house for needlepoint goods:

Number	Date	Amount
11955	7/12/74	$ 32.80
143	1/2/75	84.35
273	2/26/75	73.75
		$190.90

The proceeds of these checks were used to purchase needlepoint materials.

In November 1973, petitioner purchased some records from the Chival/Stanyan Company for $40.45. These records were paid for by a check for that amount, number 11352, drawn on the special account payable to Chival/Stanyan Co. The stub corresponding to this check was properly completed by petitioner.

The total of all payments made on petitioner's Strawbridge and Clothier (hereafter "Strawbridge") charge account in 1973 is $2,853.40. This entire amount was paid by checks drawn by petitioner on the special account. These checks form part of the basis for respondent's determination of the deficiency for 1973. The total of all payments made on petitioner's Strawbridge account in 1974 is $1,600.35. Of this amount, $1,580.35 (all but $20) was paid by checks drawn on the special account which form part of the basis for the 1974 deficiency. The total of all payments made on petitioner's Strawbridge charge account between

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January 1, and August 1, 1975, is $864.44. This entire amount was paid by checks drawn on the special account which form part of the basis for the 1975 deficiency.

In 1973, a total of $382.84 in checks drawn on the special account was paid on petitioner's Mastercharge account with the Provident National Bank and, in 1974, a total of $973.70 in checks drawn on the special account was paid on her Mastercharge account. Additionally, a check for $79.94 (number 12397) was paid on Mr. Moskovitz's Mastercharge account in 1974. In 1975, a check for $248.06 (number 201) was drawn on the special account, and credited to Mr. Moskovitz's Mastercharge account. These checks form a part of the basis for the 1973, 1974, and 1975 deficiencies, respectively.

In 1973, a total of $178.86 in checks drawn on the special account was paid on petitioner's Bankamericard account with the Philadelphia National Bank and, in 1974, a total of $528.34 in checks drawn on the special account was paid on her Bankamericard account. In addition, in 1975, a total of $592.05 in checks was paid on Mr. Moskovitz's Bankamericard account. These checks all form a part of the basis for the 1973, 1974, and 1975 deficiencies, respectively. Mr. Levy did not have a Bankamericard from Philadelphia National Bank during the years in issue.

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In 1973 and 1974, a total of $297.62 and $1,388.52 in checks drawn on the special account was paid to Bloomingdales. These checks form part of the basis for the 1973 and 1974 deficiencies. Mr. Levy had a charge account at this store during the years in issue.

The following checks were drawn on the special account payable to Sears department store.

Check No.	Date	Amount
11222	8/22/73	$221.23
11816	5/13/74	135.52
12300	11/8/74	24.24
148	1/8/75	61.52
172	1/13/75	74.19
217	2/11/75	31.79
399	5/19/75	453.00

Check numbers 11816, 148, and 217 were credited to petitioner's charge account at Sears. The checks numbered 172 and 399 were credited to Mr. Moskovitz charge account at Sears, and the checks numbered 11222 and 12300 were credited to Mr. Levy's charge account. These checks all form part of the basis for the deficiencies determined for 1973, 1974, and 1975.

In 1973, a check for $122.78 (number 11420) was drawn on the special account payable to Bamburger's department store, and credited to petitioner's charge account at that store. In 1974, a total of $570.57 in checks drawn on the special account was credited to her charge account at Bamburgers. These checks form a part of the basis for respondent's deficiency determination for 1973 and 1974.

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During 1974, there was a total of $859 paid with checks drawn on the special account payable to Friedman and Raph, petitioner's landlord, as rent on her apartment. This amount represents rent for the 5-month period of June through October, paid between May 13 and August 12, 1974.

In 1973, a total of $270.14 in checks drawn on the special account was paid on petitioner's charge account at Bonwit Teller.[4] In 1974, a check for $93 (number 11995) was drawn on the special account payable to Bonwit Teller and credited to her charge account at that store.

In 1973, a total of $132.01 in checks drawn on the special account were credited to petitioner's charge account at Gimbel's department store and, in 1974, a check for $20 (number 11502) was drawn on the special account payable to Gimbels and credited to her charge account at that store.

In 1973, checks totaling $84 were drawn on the special account payable to Lintree Hosiery. Lintree Hosiery is a mail order company from which petitioner ordered hosiery herself and other office employees. She collected money to cover the cost of

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We note that in November of 1973, petitioner bought a coat at Bonwit Teller for $84 which was charged to her account at that store. In December of 1973, a check for $84, number 11431, was drawn on the special account payable to Bonwit Teller. The corresponding checkbook stub was properly completed by petitioner.

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the orders she took from various office employees directly from those employees. The money collected was never returned to Mr. Levy.

In 1973, a check for $30.40 (number 11334) was drawn on the special account payable to Current, Inc., a mail order company specializing in greeting cards and writing supplies. The stub corresponding to this check was properly completed. In addition, in 1974, the following checks were drawn on the special account payable to Current, Inc.:

Check No.	Date	Amount
11934	7/8/74	$18.62
11998	7/30/74	30.00
12116	9/23/74	13.40
	Total for 1974	$62.02

The stubs that correspond to these checks do not indicate that Current, Inc., was the payee.

In 1974, a check for $35.50 (number 11993) was drawn on the special account payable to Frank Lewis Company, a mail order company located in Texas specializing in grapefruit gift packages. The checkbook stub corresponding to this check indicates a different payee. In addition, a check for $48.60 (number 141) was drawn on the special account in 1975 payable to Frank Lewis Co. The corresponding checkbook stub for this check was properly completed.

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In 1973, a check for $29.81 (number 11006) was drawn on the special account payable to the Country Gourmet. The stub corresponding to this check indicates a different payee. In addition, the following checks were drawn on the special account in 1974 payable to the Country Gourmet:

Check No.	Date	Amount
11505	1/4/74	$41.15
11882	6/7/74	17.44
11921	6/25/74	20.29
	Total for 1974	$78.88

The stub corresponding to check number 11505 was properly completed, but the stubs corresponding to check numbers 11882 and 11921 indicate payees other than Country Gourmet.

In 1973, a check for $72.90 (number 11286) was drawn on the special account payable to Figi's, a mail order company. The stub corresponding to this check however, indicates a different payee. In 1975, a check for $19.85 (number 223) was drawn on the special account payable to Figi's. The stub corresponding to this check does not indicate any payee. The order form which accompanied check number 223 instructed Figi's to send the items purchased to petitioner's nephew, Michael Salomone.

In 1973, the following checks were drawn on the special account payable to Miles Kimball, a mail order company located in Wisconsin:

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Check No.	Date	Amount
11290	9/24/73	$14.21
11353	11/1/73	19.52
	Total for 1973	$33.73

The stub corresponding to check number 11290 indicates a payee other than Miles Kimball, but the stub relating to check number 11353 was properly completed. In addition, in 1974, the following checks were drawn on the special account payable to Miles Kimball:

Check No.	Date	Amount
12044	8/15/74	$23.65
12105	9/19/74	14.59
	Total for 1974	$38.24

The stub relating to check number 12044 does not indicate any payee, but the stub corresponding to check number 12105 was properly completed. Finally, in 1975, the following checks were drawn on the special account payable to Miles Kimball:

Check No.	Date	Amount
220	2/18/75	$26.50
502	6/16/75	26.68
509	6/18/75	40.91
	Total for 1975	$94.09

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The stub relating to check number 220 was properly completed, the stub corresponding to check 502 does not indicate any payee, and the stub corresponding to check number 509 indicates a different payee.

In 1973, the following checks were drawn on the special account payable to Gerity Products, Inc.:[5]

Check No.	Date	Amount
11219	8/20/73	$ 46.92 [6]
11329	10/18/73	84.77
11428	11/26/73	30.69
	Total for 1973	$162.38

These checks were drawn on the special account to pay for silver items ordered by petitioner. The corresponding stub for check number 11219 was properly completed, but the stubs for check numbers 11329 and 11428 indicate payees other than Gerity Products.

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5 A letter from Gerity Products concerning these checks was to be made a part of the record in this case; it was designated exhibit 41-AO in the parties' second stipulation of fact. The Court did not receive this letter, and the parties have not been able to supply a copy. The parties have agreed informally that the letter is not necessary to a disposition of any particular issue concerning Gerity Products.

6 Mr. Levy was reimbursed for the amount of check number 11219 by a company for which he worked.

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In 1974, the following checks were drawn on the special account payable to Joan Cook, a mail order company located in Florida:

Check No.	Date	Amount
12112	9/19/74	$30.65
135	12/30/74	12.95
	Total for 1974	$43.60

The checkbook stub corresponding to check number 12112 does not indicate any payee, and the stub for check number 135 indicates a payee other than Joan Cook. In addition, in 1975, a check for $54.20 (number 425) was drawn on the special account payable to Joan Cook. The corresponding stub for this check does not indicate any payee.

In 1973, the following checks were drawn on the special account payable to Kenton Collection:

Check No.	Date	Amount
11320	10/2/73	$116.25
11335	10/21/73	90.90
	Total for 1973	$207.15

The checkbook stubs corresponding to these checks indicate payees other than Kenton Collection.

In 1974, the following checks were drawn on the special account payable to Bailey, Banks and Biddle, a jewelry store in Philadelphia:

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Check No.	Date	Amount
11876	5/31/74	$63.07
12143	10/7/74	23.32
		$86.39

The stubs relating to both of these checks were properly completed by petitioner.

In 1975, the following checks were drawn on the special account payable to Discovery House, a mail order company located in Connecticut:

Check No.	Date	Amount
388	4/29/75	$39.75
428	5/15/75	40.40
	Total for 1975	$80.15

The stubs corresponding to both of these checks were properly completed by petitioner.

In 1973, a check for $42 (number 11072) was drawn on the special account payable to Lord and Taylor, a department store and in 1974, a check for $111.80 (number 12374) was drawn on the special account payable to the same store. The checkbook stub for both these checks were properly completed.

In 1973, the following checks were drawn on the special account payable to "Rich's":

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Check No.	Date	Amount
10883	3/14/73	$82.15
11282	9/10/73	31.19
	Total for 1973	$113.34

The stub relating to check number 10883 was properly completed, but the stub corresponding to check number 11282 indicates a different payee.

In 1974, a check for $26.03 (number 12060) was drawn on the special account payable to J.C. Penney. The corresponding checkbook stub for this check indicates a different payee. Additionally, in 1975, a check for $263.88 (number 514) was drawn on the special account payable to J.C. Penney, and credited to petitioner's charge account at this store. Mr. Levy did not have an account at J. C. Penney during the 3 years in issue.

In 1973, the following checks were drawn on the special account payable to Saks Fifth Avenue, a department store:

Check No.	Date	Amount
10992	5/7/73	$ 66.00
11263	9/5/73	130.00
11325	10/5/73	41.00
11355	11/6/73	50.50
	Total for 1973	$287.50

The stubs relating to these checks were properly completed by petitioner. In addition, the following checks were drawn on the special account payable to Saks Fifth Avenue in 1974:

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Check No.	Date	Amount
12041	8/7/74	$135.25
12102	9/16/74	271.61
12140	10/7/74	58.00
12308	11/8/74	46.40
	Total for 1974	$511.26

The stub relating to check number 12041 indicates a different payee, but the stubs corresponding to check numbers 12102, 12140, and 12308 were properly completed. In 1975, a check for $175 (number 525) was drawn on the special account payable to Saks Fifth Avenue. The checkbook stub for this check was properly completed.

In 1973, the following checks were drawn on the special account:

Check No.	Date	Payee	Amount
10921	3/22/73	Savoy Co.	$ 30.00[7]
10925	3/28/73	Hess's	309.30
11075	6/11/73	Benson's	44.00
11139	7/3/73	Nice Pak	15.00
11212	8/7/73	Hattie Carnegie	29.50
		Total for 1973	$427.80

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[7] Respondent has conceded that check number 10921 represents a payment made for the benefit of Mr. Levy.

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Check number 10925 was credited to petitioner's charge account at Hess's, a department store in Philadelphia. Mr. Levy did not have an account at Hess's in 1973. The checkbook stubs corresponding to check numbers 10921, 11075, and 11139 were properly completed by petitioner, but the corresponding stub for check number 11212 indicates a payee other than the one shown above.

The following checks were drawn on the special account in 1974:

Check No.	Date	Payee	Amount
11498	1/4/74	St. Hubert's Alumni	$ 60.00
11499	1/4/74	Barbara Corbin	56.20
11889	6/17/74	Temple Music Fair	16.00
11992	7/29/74	Fosdick Corp.	10.00
12061	8/20/74	5 Minute Shapeup	10.95
12062	8/24/74	Drake and Sons	32.17
12064	8/26/74	Gourmet Books	36.00
12113	9/19/74	Harriet Carter	17.89
12136	10/1/74	Curtin Publications	10.26
12146	10/10/74	Pepperidge Farm	28.10
		Total for 1974	$277.57

The checkbook stubs for check numbers 11498, 11992, and 12113 indicate payees other than those shown above, the corresponding stubs for check numbers 11499, and 12146 do not indicate any payee at all, and the stubs to check numbers 12062, 12064, and

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12136 were properly completed by petitioner. Check number 11889, payable to Temple Music Fair, was payment for concert tickets, and check number 12061, payable to 5 Minute Shapeup, was payment for an exercise wheel. Petitioner wrote a check (number 11498) drawn on the special account payable to St. Hubert's Alumni Association to pay for a fashion luncheon put on by the St. Hubert's Alumni Association. Petitioner took money from Janet Szlachta ostensibly to cover the cost of her ticket.

The following checks were drawn on the special account in 1975:

Check No.	Date	Payee	Amount
210	1/30/75	Chevron	$155.80
283	3/11/75	Jean Coren	31.15
335	3/31/75	Forrest Theatre	21.80
336	3/31/75	Fingerhut	23.96
427	5/12/75	Temple Music Fair	34.00
		Total for 1975	$266.71

The stubs corresponding to check numbers 336 and 427 were properly completed, but the checkbook stubs for check numbers 283 and 335 indicate payees other than those shown above. Check number 210 was credited to Mr. Moskovitz's Chevron charge account and check number 335, payable to the Forrest Theatre, represents payment for theater tickets. Finally, the proceeds of check number 427, payable to Temple Music Fair, were used to pay for concert tickets.

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Petitioner had a power of appointment, granted by Mr. Levy, which allowed her to sign checks drawn on the special account. She and Mr. Levy were the only persons with authority to sign checks drawn on the special account from January 1, 1973 to August 14, 1975. Mr. Levy often drew checks on the special account when he needed cash, and on these occasions he would himself write out a check payable to "cash". If he was going to be out of town, he would often take some blank checks from the special account with him in case he needed cash while he was away. Other times, he would ask petitioner to make out the check, cash it and bring him the cash.

Janet Szlachta went through the records that were available concerning the special account for the years in issue, and compiled a list of questionable checks that had been drawn by petitioner payable to "cash". The criteria used by Janet to identify questionable checks were (i) Mr. Levy was out of town when the check was cashed, (ii) there was a discrepancy between a check and the stub to which it corresponded, and (iii) Mr. Levy had obtained cash himself by means of another check written on the same date. If any one of these circumstances existed with respect to a particular check, Janet noted that check on her list. Respondent included the amount of checks drawn on the special account to cash in the deficiencies for the years in issue on the same basis.

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Though petitioner was not formally trained as a bookkeeper, she did take some accounting courses and she did manage several bank accounts for Mr. Levy. A formal set of books was maintained for all of the accounts except the special account. Mr. Levy did not require that a set of books be kept for the special account because it was a personal account, used solely to pay his personal bills. Items that were deductible for Federal income tax purposes were paid out of the accounts for which books were kept. These books were regularly reviewed by an accountant employed by the company for which Mr. Levy worked. There were never any irregularities discovered in the books thus reviewed, but the accountant did not review the special account.

Ms. Szlachta determined that Mr. Levy was out of town on the dates indicated on the chart below by reference to his own personal calendars, a 1973 calendar maintained by petitioner, and other calendars maintained in Mr. Levy's office. Ms. Szlachta utilized these calendars in order to determine Mr. Levy's whereabouts on the dates when the "cash" checks were written on the special account by petitioner. Ms. Szlachta discussed each entry with Mr. Levy and she also reviewed airline tickets to determine the exact dates on which Mr. Levy was out of town. We also note that Mr. Levy resided at the New Jersey shore during the summer months of the years in issue.

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There were many checks drawn to "cash" on the special account that were not included in the deficiency determined by respondent. This is because Mr. Levy occasionally drew cash checks himself and sometimes took blank checks from the special account. The checks payable to cash that are in issue were included in the deficiency for the taxable years 1973, 1974, and 1975 because, according to respondent, the proceeds of these checks were used for petitioner's personal benefit. Each of the checks in issue were written on the special account by petitioner.

The following chart, based on exhibit BA, consists of the 70 checks payable to cash which were included by respondent in petitioners' income for the taxable years 1973, 1974, and 1975. The chart includes the check number, date, amount, notation on the check stub, and/or the whereabouts of Mr. Levy on the date of the check. As noted above, the checks listed are included in the understatements for the 3 years in issue either because Mr. Levy was out of town when the check was cashed, there was a discrepancy between the check and the corresponding checkbook stub, or it was determined that Mr. Levy had obtained cash himself by means of another check written on the same date.

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"Cash" Checks--Money unaccounted for by Robert Levy (1973)

PAYEE	CHECK NO.	DATE	AMOUNT	EXPLANATION[8]
Cash	10762	1/19/73	$1,500	Stub-Francis S. McKelvey/N.Y. and Fla. (cashed check #10736, $1,000, 1/18/73).
Cash	10845	2/13	1,500	Stub-Phoebe Widmer, $150/N.Y. 2/13-2/15 P.M.
Cash	10907	3/16	500	Stub-Stein, Henry/Charlotte, N.C., 3/14 thru 3/16.
Cash	10996	5/15	400	Out of town 5/14 thru 5/21, golf outing.
Cash	10997	5/18	200	Out of town 5/14 thru 5/21, golf outing.
Cash	11076	6/11	340	Stub-Lawrence J. Norton.
Cash	11081	6/15	200	N.Y. 6/14-6/15.
Cash	11082	6/15	500	From N.Y. 6/15 to Margate for weekend.
Cash	11195	8/7	1,000	Stub-Jr. Baseball Federation.
Cash	11216	8/9	250	Stub-Little Quakers - pay back loan ck. 11215, 8/9/74, $250 (Little Quakers pay back loan).

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8 Each explanation includes a description of why a particular check was brought into question. The dates and locations refer to Mr. Levy's whereabouts for the date on which the check was cashed. A reference such as "Stub-Francis S. McKelvey" refers to the fact that the stub contained a notation that the check was payable to Francis S. McKelvey. In addition, a reference such as "cashed check #10736, $1,000, on January 18, 1973" refers to the fact that Mr. Levy received cash from check number 10736 in the amount of $1,000 on January 18, 1973.

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Cash	11217	8/9	$ 500	Monmouth--all day.
Cash	11220	8/22	700	Stub-Cash, $200.
Cash	11249	8/23	100	Stub-Cash, Mrs. Levy--endorsed by James Hogan.
Cash	11266	9/6	250	Mr. Levy at Atlantic City Racing Assoc. 9/1 thru 9/17.
Cash	11285	9/13	1,000	Same as above.
Cash	11288	9/27	300	Mr. Levy at Atlantic City Racing Assoc. 9/24 thru 9/28.
Cash	11322	10/4	1,000	Mr. Levy at Atlantic City Racing Assoc. all day.
Cash	11330	10/19	200	Florida 10/17-10/18, Lehigh 10/19.
Cash	11331	10/19	300	Same as above.
Cash	11416	11/15	250	Stub-McKelvey & Son.
Cash	11426	11/21	500	Mr. Levy cashed own check at Atlantic City Racing Assoc. #11426, 11/21/73.
Cash	11436	12/11	250	Mr. Levy at Atlantic City Racing Asso. in A.M.; to N.Y. with Dr. Levy.
Cash	11448	12/17	1,500	Stub-Nan Duskin/Mr. Levy in New Orleans, Las Vegas & Florida, 12/15 thru 12/29.
Cash	11493	12/20	1,500	Mr. Levy in New Orleans, Las Vegas and Florida 12/15 thru 12/29.
	1973 Total		$14,740	

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"Cash" Checks--Money unaccounted for by Robert Levy (1974)

Cash	11586	2/14/74	$ 340	Stub-Lawrence S. Norton.
Cash	11642	2/20	1,200	Stub-Void.
Cash	11647	3/1	600	Stub-$500.
Cash	11649	3/8	200	Mr. Levy to Detroit 3/6 to N.Y. ret. 3/8; He took check #11650 ($5,000) on 3/8.
Cash	11657	3/14	300	Stub-blank/Mr. Levy, Conn.
Cash	11755	4/17	1,000	Stub-$10.
Cash	11814	5/9	800	Stub-$500.
Cash	11823	5/17	500	Stub-blank.
Cash	11875	6/3	700	Stub-Meyers $7/Mr. Levy meeting Marco Island ret. 6/4.
Cash	11879	6/6	200	Stub-blank.
Cash	11917	6/17	225	Stub-$25 reimbursement for money spent on gift certificate for Linda Magoon.
Cash	11920	6/25	200	Mr. Levy-Montreal, 6/24 -6/29.
Cash	11927	7/1	500	Mr. Levy-Ocean Beach Club, 7/1-7/7, took blank check with him.
Cash	11932	7/3	200	Same as above.
Cash	11938	7/10	600	Stub-$600.
Cash	12038	8/8	2,700	Stub-void.
Cash	12050	8/16	600	Stub-Bonwits/Mr. Levy in Monmouth A.M./N.H. noon.
Cash	12097	9/10	300	Mr. Levy-Lexington, KY-9/10.
Cash	12139	10/4	300	Mr. Levy-Atlantic City Racing Assoc., took check #12138-$2000.

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Cash	12335	11/8	$ 300	Stub-void-ck. #12335, $500 cash for Mr. Levy, 11/8.
Cash	12256	11/25	500	Stub-Saks, $711.79.
Cash	12257	12/13	200	Stub-Bloomingdale's, $186.45.
Cash	133	12/30	1,000	Mr. Levy-Hawaii 12/23-12/30, 12/30 Phoenix.
	1974 Total		$13,465	

"Cash" Checks - Money unaccounted for by Robert Levy (1975)

Cash	156	1/10/75	500	Stub-Lamps-Mary, $269-Wage Electric Co.
Cash	12258	1/17	500	Stub-Mary Kemp, $50.
Cash	208	1/21	200	Stub-Void.
Cash	207	1/27	200	Stub-Sears, $200-Void.
Cash	272	2/24	400	Stub-Cash, $100.
Cash	282	3/7	300	Stub-Void/Mr. Levy-Greensboro, N.C. 3/5, ret. 3/7 evening.
Cash	285	3/12	1,300	Stub-$300.
Cash	320	3/14	500	Stub-Blum Store, $465.13.
Cash	332	3/21	500	Stub-Void.
Cash	333	3/26	500	Stub-Void/Mr. Levy-Bahamas 3/25, ret. to Phila. on 3/30, and left for Fla. thru 4/2.
Cash	398	4/29	300	Mr. Levy took ck. #424 on 4/29, ($500).
Cash	441	5/8	100	Mr. Levy-Geneva, London & Athens 5/6 thru 5/16.
Cash	442	5/12	100	Same as above.
Cash	459	5/22	$3,000	Stub-Void
Cash	454	6/3	1,500	Stub-Phila. Traffic Court, $15.

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Cash	507	6/16	$ 200	Stub-blank/Mr. Levy-Denver 6/13 thru 6/17.
Cash	520	6/20	200	Stub-Void/Mr. Levy at Atlantic City Racing Assoc. all day.
Cash	513	6/25	1,500	Stub-Traffic Court, $15/Mr. Levy-Dallas 6/24-6/26.
Cash	547	6/27	1,500	Stub-blank, $15/Mr. Levy-Atlantic City Racing Assoc.
Cash	556	7/15	800	Mr. Levy at Atlantic City Racing Assoc. all day.
Cash	567	7/17	1,000	Stub-$100/Mr. Levy at Atlantic City Racing Assoc. all day.
Cash	592	7/21	500	Mr. Levy-Lexington 7/20-7/22 to Pomona, N.J. in evening.
Cash	453	5/29	300	Mr. Levy-Monmouth Park.
	1975 Total		$15,900	

Mr. Moskovitz and petitioner were married on November 30, 1974, and thus were permitted to and did file joint Federal income tax returns for 1974 and 1975. Mr. Moskovitz first learned that there was a question regarding the Levy Special Account and his wife's possible embezzlement activities when a summons was delivered to his home in March 1976. We note that Mr. Moskovitz signed the couple's 1975 tax return in January of 1976, well before the date that the summons was delivered.

At home, petitioner wrote most of the personal checks for herself and her husband. She paid the bills, retained most of their credit cards, made the bank deposits for both, reconciled their bank statements, kept all of the financial books and rarely

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consulted her husband about any of these matters. She also deposited Mr. Moskovitz's paycheck and gave him just enough for spending money. Mr. Moskovitz did not receive any expensive gifts from petitioner while they were married in 1974 or 1975. He purchased his car by trade-in and long-term financing, and paid for his and his wife's honeymoon with his own personal savings. Mr. Moskovitz and petitioner purchased their residence with money they borrowed from petitioner's father. Mr. Moskovitz did not receive any significant benefit either directly or indirectly from the income items which were omitted from petitioners' gross income during the years in issue.

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OPINION

Amount of Embezzlement Income

The first issue for decision is the amount of income petitioners must recognize from petitioner's embezzlement activities. Respondent asserts that petitioner misappropriated funds from her employer, Mr. Levy, which she failed to include in her gross income in each of the taxable years 1973 through 1975. We agree.

Section 61(a) defines gross income as "all income from whatever source derived * * *." Section 1.61-14(a), Income Tax Regs., provides that "[i]llegal gains constitute gross income." Moreover, it is well-established that embezzled funds constitute gross income to the embezzler in the year the funds are misappropriated. Solomon v. Commissioner, 732 F.2d 1459, 1460-1461 (6th Cir. 1984), affg. per curiam a Memorandum Opinion of this Court; Rappaport v. United States, 583 F.2d 298, 302 (7th Cir. 1978); Bailey v. Commissioner, 420 F.2d 777, 778 (5th Cir. 1969), affg. per curiam 52 T.C. 115 (1969); Nerem v. Commissioner, 41 T.C. 338, 341-344 (1963).

When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent" * * * In such case, the taxpayer has "actual command over the property taxed--the actual benefit for which the tax is paid." * * * [James v. United States, 366 U.S. 213, 219 (1961)].

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Petitioners contend that respondent has the burden of proving that they received unreported income during the 1973, 1974, and 1975 taxable years, and that petitioners failed to report such income on their Federal income tax returns. Petitioners cite Taylor v. Commissioner, 70 F.2d 619, 621 (2d Cir. 1934), as authority for the proposition that where respondent's Notice of Deficiency alleges omissions from taxable income, the burden of proof rests upon the Government. Respondent alleges that petitioners' reliance on Taylor is misplaced. We agree with respondent.

The Taylor court clearly upheld the traditional view that the burden of proof with respect to respondent's deficiency determination is on petitioner. Rule 142(a)[9]; Welch v. Helvering, 290 U.S. 111 (1933). Only after proving respondent's determination to be erroneous, would the Taylor court relieve the taxpayer of the burden of proving that he did not owe any tax.

> [T]he taxpayer has the burden of proving * * * [respondent's deficiency] was wrong, after he has done so, he need not * * * prove that he owed no tax, or what was the tax that he did owe. The original assessment rested upon a finding, presumptively correct, but the presumption of its correctness does not extend to other findings which the Commissioner has never made. * * * [Taylor v. Commissioner, supra at 621.]

Petitioners' reliance on Weir v. Commissioner, 283 F.2d 675, 679 (6th Cir. 1960), is similarly inappropriate. In Weir, the Court of Appeals for the Sixth Circuit held that no presumption of correctness attached to the Commissioner's determination and

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9 All references to "Rules" are to the Tax Court Rules of Practice and Procedure.

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that the Government had to affirmatively prove its case. This, result occurred however, because respondent conceded that his determination was erroneous with respect to a substantial amount, this Court found an error in respondent's determination as to an additional amount, and petitioner gave clear and uncontradicted testimony that he had not received certain of the alleged income he was being charged with. In Weir, respondent failed to present any affirmative evidence whereas, in the instant case, respondent has presented substantial documentary and testimonial evidence supporting the Commissioner's deficiency determinations and we therefore find the facts and the reasoning in Weir to be inapposite.[10]

Procedure for Determining Amounts of Understatements for 1973, 1974 and 1975

Petitioner worked for Mr. Levy as his personal secretary and bookkeeper. She managed several bank accounts for him in this capacity including one called the special account out of which Mr. Levy paid his personal expenses. No formal books were kept for this account. Petitioner had a power of attorney which allowed her to sign checks drawn on the special account.

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10 See also Schildhaus v. Commissioner, T.C. Memo. 1969-283, affd. per curiam 442 F.2d 1343 (2d Cir. 1971) (petitioners sustained their burden of proving that certain moneys found in decedent's safe deposit box were acquired in a year other than that determined by respondent), and Estate of Nasdeo v. Commissioner, T.C. Memo. 1968-60 (petitioners sustained their burden of proof by showing that a portion of certain unexplained disbursements were not taxable income).

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The deficiencies in this case are based on individual checks drawn on the special account by petitioner that inured to her benefit, and which Mr. Levy claims were not authorized. Specific testimony has been offered to support respondent's determinations.[11]

We believe that petitioner did embezzle money from Mr. Levy. She was able to do so essentially as follows: She maintained the checkbook for the special account. She would submit bills to Mr. Levy that had to be paid and he would write checks from another account in an amount sufficient to allow the bills to be paid from the special account once these checks from the other account had been deposited into the special account. In order to do this, of course, Mr. Levy had to know the current balance in the special account. He would simply ask petitioner what it was. Petitioner did not keep a running balance in the checkbook, so he could not otherwise check. By systematically understating the balance in the account, petitioner could build up substantial reserves which she then drew on by writing unauthorized checks to cash, and by writing unauthorized checks to petitioners' creditors.

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[11] Petitioners argue, on brief, that they were denied access to the materials and documents which would enable them to meet the allegations of respondent. We dismiss petitioners' assertion because it is unsupported and without merit. We also note that the Tax Court Rules of Practice and Procedure offer both parties ample opportunity to seek redress for any abuses that might occur during the discovery process. See Rule 104.

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The same result was sometimes obtained in a slightly different manner: if petitioner and Mr. Levy happened to have a charge account at the same store, petitioner would sometimes submit one of Mr. Levy's bills from that store to him, along with other bills, and he would write a check from another account to cover the bills thus submitted in an amount sufficient to allow the bills to be paid from the special account once the check had been deposited. Petitioner would then write a check to that store and have it credited to her own account. If Mr. Levy found out that his bill had not been paid, petitioner would make some excuse which would allow her to resubmit the bill to Mr. Levy who would then write another check to provide for its payment.[12]

We do not, however, believe that petitioner embezzled as much money as respondent alleges she did. On the facts before us, the volume of checks drawn on the special account which apparently inured to petitioner's benefit is extraordinary. For example, between January 1, 1973 and August 1, 1975, (at which point petitioner left Mr. Levy's employ) a total of $3,378.10 was

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Janet Szlachta compared the checks written to third parties against invoices contained in Mr. Levy's files to determine to whose accounts the payments had been credited. She wrote to all the stores at which Mr. Levy had an account to determine if canceled checks payable to those stores had been applied to Mr. Levy's account. Janet also wrote to all the stores to which canceled checks drawn on the special account had been sent and where Mr. Levy did not maintain an account. She contacted third party payees of the questionable checks from the special account in order to determine to whose accounts the payments were credited. Based on the responses received from third party payees, it was determined that certain checks drawn on Mr. Levy's special account had been credited to petitioner's own personal accounts.

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paid on petitioner's charge account at Wanamaker's. Of this amount, all but $13 was paid by checks drawn by petitioner on the special account.

On occasion, Mr. Levy had petitioner buy things on her own charge accounts, for him, his friends, and his family, and he would reimburse her either directly or by paying her creditor. This reimbursement would be effected by a check from the special account, which probably would have been drawn by petitioner herself. This clearly occurred far more often than Mr. Levy (whom we did not find to be a particularly credible witness) now admits. In particular, we seriously doubt that Mr. Levy would have failed to notice that approximately $20,000 per year was being siphoned off of his personal checking account. The best we can do in this case is to look at each check which forms a part of the deficiency, and ask whether the record supports the conclusion that it was drawn at Mr. Levy's behest, or covertly by petitioner for her own benefit.

The checks which form the basis for the deficiencies determined in this case fall into two broad categories: (1) checks made payable to third parties; and (2) checks made payable to cash. The checks made payable to third parties have been called into question because either (a) they were paid to one of petitioners' creditors, e.g., credited to one of petitioners' charge accounts at a store (See Appendix I); (b) the stubs in the checkbook indicate a payee or amount different from that indicated on the corresponding check (see Appendix II); or (c)

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Mr. Levy does not recall buying anything from the indicated payee. We will accept the first two of these criteria as probative of embezzlement. The last criteria, however, must be rejected because we find Mr. Levy often had petitioner purchase items for his family and friends, and he left it to petitioner to order or pick up such things. That Mr. Levy does not remember sending a fruit basket to a friend, or that he forgot certain other items, did not particularly impress us. Additionally, the law imposes a lesser burden upon a taxpayer who is called upon to prove a negative (e.g., that he did not receive the income which the Commissioner claims he received) than is imposed upon a taxpayer who is attempting to sustain a deduction. Weir v. Commissioner, 283 F.2d 675 (6th Cir. 1960), remanding a Memorandum Opinion of this Court. See also Taylor v. Commissioner, 70 F.2d 619, 621 (2d Cir. 1934), affd. 293 U.S. 507 (1935).

> One reason for this is that * * * deductions are matters of legislative grace, and the burden of proving them and their correct amount rests upon the taxpayers, entirely aside from the consideration of any presumption of correctness that attaches to the Commissioner's determination * * *. [Weir v. Commissioner, supra at 679.]

Thus, we believe that petitioner meets her burden of proof where she is able to show that there is no rational basis for the inclusion of the amount of a check in the understatement. Therefore, if a check is not suspicious by virtue of one of the first two criteria set forth above, we will reduce the

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understatement for the year in which the check was drawn, notwithstanding that Mr. Levy testified that he does not remember authorizing the check in question.

As to checks paid to petitioners' creditors, we find that Mr. Levy did sometimes have petitioner purchase things for him on her own charge accounts. He would sometimes reimburse her by paying her creditors. Therefore, where petitioner gave a credible account of a particular purchase on her charge, the amount of that purchase was subtracted from the understatement in the year in question.

As to discrepancies between checks and corresponding stubs, as we shall note below, this criteria was also used to include checks drawn to cash in the understatements as well. Petitioner has argued that she was just very "sloppy" about keeping records for this account. We find that she was too sophisticated in general, and too competent as a bookkeeper in particular, to have been as consistently sloppy as she claims.[13] On the other hand, we believe she was sloppy to some degree, and made some mistakes not attributable to sloppiness. Therefore, where petitioner gave a credible account of a purchase or cash transaction, the amount

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13 As noted above, the books maintained by petitioner were regularly reviewed by an accountant employed by the company for which Mr. Levy worked. There were never any irregularities discovered in the books thus reviewed, but the accountant did not review the special account.

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thereof was subtracted from the understatement for the year in issue, notwithstanding that the check and stub involved do not match.

Checks payable to "cash" have been called into question because either (a) the check and corresponding stub do not match; (b) Mr. Levy was out of town on the day the check was drawn--and so presumably would not have asked petitioner to get him any cash on that particular date; or (c) Mr. Levy obtained cash by another check, which he himself signed, on the same date. We accept all of these criteria as probative of embezzlement, subject, however, to a satisfactory explanation by petitioners. Where, for example, petitioner wrote someone's name in the space provided for the payee on a check stub, and Mr. Levy admitted that the person named is someone to whom he might have given the amount in question, the understatement in question was reduced by this item.

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A. Checks Drawn on the Special Account, Payable to Third Parties and Removed from the Understatement

(1) Respondent has conceded that a check in the amount of $30 (No. 10921) payable to the Savoy Company represents a payment for the benefit of Mr. Levy. We will reduce the 1973 understatement accordingly.

(2) Petitioner purchased certain items for friends and associates of Mr. Levy at his request. For instance, in April of 1973, she bought a "baby set" at Wanamaker's for Mr. Levy to give as a gift to the wife of a friend. The cost of the baby set ($32) was charged to petitioner's own account at the store. In May 1973, a check for $60.50 (No. 10989) was drawn on the special account and credited to petitioner's account at Wanamaker's. The corresponding check stub matches the check in issue. We will reduce the 1973 understatement by $32.[14]

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14 Mrs. Levy and the Levy children were not called to testify in this case, but it was agreed, at the time of trial, that if they had been called, they would have testified as follows with respect to items petitioner claims to have purchased for them:

> That they may have received some of these items; that they have no recollection of receiving other items but might have; that if they did receive any of these items, they were not able to remember specifics as to when the items were received, nor can they remember who may have purchased any specific item on any specific occasion. As to the Levy children, they do not remember whether or not they ever went shopping with petitioner, and if they did, they would not be able to remember whether anything was purchased.

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(3) In June 1973, petitioner purchased two swimsuits and two games at Wanamaker's for a total of $59.36 all of which amount was charged to her own account at the store. The swimsuits were purchased by Mary for one of Mr. Levy's friends and the two games were purchased for the Levy children. In July 1973, a check for $126.99 (No. 11140) was drawn on the special account at Wanamaker's and credited to petitioner's account. The stubs corresponding to these checks were properly completed by petitioner. We will reduce the 1973 deficiency by $59.36.

(4) In August of 1973, petitioner bought a record (or some records) for Mr. Levy's daughter at Wanamaker's. She made this purchase by placing a charge of $2.86 on her own account at that store. In September of 1973, a check for $45.86 (No. 11262) was drawn on the special account payable to Wanamaker's and credited to petitioner's account at that store. The checkbook stub corresponding to check number 11262 was properly completed by petitioner. We will reduce the 1973 understatement by $2.86.

(5) In January of 1974, petitioner bought a backgammon game and two puzzles for Mr. Levy's children at Wanamaker's. The cost of these items ($16.94) was charged to petitioner's own account at the store. In February 1974, a check for $41.94 (No. 11581) was drawn on the special account payable to Wanamaker's and credited to petitioner's account. The stub corresponding to this check was properly completed by petitioner. We will reduce the 1974 understatement by $16.94.

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(6) Mr. Levy gave petitioner some gifts during the period that she worked for him, including an engagement present and a wedding present. In April of 1974, and in June of that year, petitioner purchased crystal at Wanamaker's for $311.64 and $114.48, respectively. These amounts were charged to petitioner's own account at the store. In May 1974, a check for $335.14, (No. 11800) was drawn on the special account payable to Wanamaker's and in July 1974, a check for $351.35, number 11936, was drawn payable to the same store. Both of these checks were credited to petitioner's account. The corresponding stubs were properly completed. Because we find that the crystal purchased on these two occasions constituted an engagement present from Mr. Levy, we will reduce the 1974 understatement by $426.12.

(7) Check number 183, in the amount of $51.08, was drawn on the special account payable to Wanamaker's. This check was part of the basis for the 1975 deficiency. Although Wanamaker's is one of petitioner's creditors, there is no evidence in the record that the check was credited to her account. We will reduce the 1975 understatement by $51.08.

(8) In November of 1973, petitioner purchased some records for Mr. Levy's daughter from the Chival/Stanyan Co. for $40.45. These records were paid for by a check for that amount (No. 11352) which was drawn on the special account payable to Chival/Stanyan Co. The stub corresponding to this check was properly completed. We will reduce the 1973 understatement by $40.45.

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(9) The following checks were drawn on the special account payable to The Horchow Collection:

Number	Date	Amount
11811	5/13/74	$ 99.60
11884	6/11/74	20.95
12101	9/13/74	110.80
12114	9/20/74	75.50
12119	9/27/74	241.70
		$548.55

The corresponding checkbook stubs were all properly completed by petitioner and these checks are not otherwise suspicious. Furthermore, there is nothing in the record to indicate that the merchandise ordered went anywhere other than to Mr. Levy's office. We will reduce the 1974 understatement by $548.55. In addition, in January of 1975, and again in June of that year, petitioner ordered items from The Horchow Collection catalog for Mrs. Levy. The orders were paid for by two checks, one for $28.20 and the other for $93.05 (Nos. 171 and 519, respectively) drawn on the special account payable to The Horchow Collection. The amounts of these checks were properly recorded on the corresponding stubs. We will reduce the 1975 understatement by $28.20 and $93.05.

(10) The following checks were drawn on the special account payable to the Stitchery, a mail order house for needlepoint.

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Number	Date	Amount
11955	7/12/74	$ 32.80
143	1/2/75	84.35
273	2/26/75	73.75
		$190.90

These checks were used to purchase needlepoint materials for Mrs. Levy or her daughters. We will reduce the 1974 and 1975 understatement accordingly.

(11) The following checks were drawn on the special account payable to Gerity Products, Inc.:

Number	Date	Amount
11219	8/30/73	$ 46.92[15]
11329	10/18/73	84.77
11428	11/26/73	30.69
		$162.38

These checks were drawn on the special account to pay for silver items ordered by petitioner for Mr. Levy's wife. We therefore will reduce the 1973 understatement by $162.38.

(12) In November of 1973, petitioner bought a coat at Bonwit Teller for one of Mr. Levy's friends for $84 which was charged to petitioner's account at that store. In December of that year, a check for $84 (No. 11431) was drawn on the special

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15 Mr. Levy was subsequently reimbursed in the amount of $46.92 by a company for which he worked.

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account which was credited to petitioner's account at Bonwit Teller. The corresponding stub was properly completed. We will reduce the 1973 understatement by $84.

(13) In 1973, a total of $297.62 in checks drawn on the special account was paid to Bloomingdale's (Nos. 10991, 11070, 11141, 11261, and 11348); and in 1974, a total of $1,388.52 in checks drawn on the special account was paid to the same store (Nos. 11501, 11799, 12066, 12132, 12134, and 12389). Mr. Levy had a charge account at this store during the years in issue. There is nothing in the record to indicate that these amounts were not credited to Mr. Levy's own account at Bloomingdale's. In addition, the checks and their corresponding stubs were properly completed by petitioner. We will reduce the 1973 and 1974 understatements by $297.62 and $1,388.52, respectively.

(14) Check numbers 11222 and 12300 were drawn on the special account payable to Sears department store in the amounts of $221.23 and $24.24, respectively. Respondent has conceded that these checks represented payments made for the benefit of Mr. Levy and we will reduce the 1973 and 1974 understatement accordingly.

(15) In 1973, a check for $30.40 (No. 11334) was drawn on the special account payable to Current, Inc., a mail order company specializing in greeting cards and writing supplies. The corresponding stub was properly completed, and the statement read

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into the record in lieu of having Mrs. Levy testify does refer to stationary. We will therefore reduce the 1973 understatement by $30.40.

(16) In 1975, a check for $48.60 (No. 141) was drawn on the special account payable to Frank Lewis Co. Although Mr. Levy does not recall ordering merchandise from this company, the corresponding stub was properly completed by petitioner and we will therefore reduce the 1975 understatement by $48.60.

(17) In 1974, check number 11505 was drawn on the special account payable to the Country Gourmet in the amount of $41.15. The stub corresponding to check number 11505 was properly completed. We will reduce the 1974 understatement by $41.15.

(18) In 1973, check number 11353 was drawn on the special account payable to Miles Kimball, a mail order company, in the amount of $19.52. The stub and the corresponding check match and we will reduce the 1973 understatement by this amount. We will reduce the 1974 understatement by $14.59 to reflect the fact that check number 12105, drawn on the special account payable to Miles Kimball, matches its corresponding stub, and we will reduce the 1975 understatement by $26.50 to reflect the fact that check number 220, drawn on the special account payable to Miles Kimball, matches its corresponding checkbook stub.

(19) In 1974, two checks were drawn on the special account (Nos. 11876 and 12143) payable to Bailey, Banks and Biddle, a jewelry store in Philadelphia, in the amount of $63.07 and

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$23.32, respectively. The corresponding checkbook stubs for both of these checks were properly completed by petitioner and we will therefore reduce the 1974 understatement by $86.39.

(20) We will reduce the 1975 understatement by $80.15 to account for the fact that the stubs corresponding to the checks numbered 388 and 428 were properly completed by petitioner. These checks were both payable to Discovery House, a mail order company.

(21) In 1973, check number 11072 for $42, and in 1974, check number 12374 for $111.80 were drawn on the special account payable to the Lord and Taylor department store. In both cases, the corresponding check stubs were properly completed by petitioner. We note that there is nothing in the record to indicate that these checks were credited to petitioner's charge account at Lord and Taylor. However, in their Request for Findings of Fact (number 109), petitioners admit that these checks were credited to petitioner's charge account. Therefore, we will make no reduction in the 1973 or 1974 understatement for these checks.

(22) The 1973 understatement will be reduced by $82.15 to reflect the fact that the stub corresponding to check number 10883, payable to "Rich's", was properly completed by petitioner.

(23) In 1973, 1974, and 1975, the following checks were drawn on the special account payable to Saks Fifth Avenue:

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Check No.	Date	Amount
10992	5/7/73	$ 66.00
11263	9/5/73	130.00
11325	10/5/73	41.00
11355	11/6/73	50.50
Total for 1973		$287.50

Check No.	Date	Amount
12102	9/16/74	$271.61
12140	10/7/74	58.00
12308	11/8/74	46.40
Total for 1974		$376.01

Check No.	Date	Amount
525	6/27/75	$175

All of the stubs corresponding to the checks listed above were properly completed. Although there is nothing in the record to indicate that any of these checks were credited to a charge account of petitioner's at Saks, Petitioners' Requested Finding of Fact (Number 109) provides that the checks in issue were credited to petitioner's account. Ms. Szlachta testified that she wrote to all the stores at which Mr. Levy had an account to determine which checks were credited to these accounts. Because Mr. Levy did in fact have a charge account at Saks during the years in issue, and because the corresponding check stubs were properly completed, we will reduce the understatement for each year accordingly.

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(24) In 1973, the following checks were drawn on the special account:

Check No.	Date	Payee	Amount
11075	6/11/73	Bensons	44
11139	7/3/73	Nice Pak	15
			$ 59

The stubs corresponding to these checks were properly completed by petitioner and therefore, we will reduce the 1973 understatement accordingly.

(25) The following checks were drawn on the special account in 1974:

Check No.	Date	Payee	Amount
11889	6/17/74	Temple Music Fair	$ 16.00
12062	8/24/74	Drake and Sons	32.17
12061	8/20/74	5 Minute Shapeup	10.95
12064	8/26/74	Gourmet Books	36.00
12136	10/1/74	Curtin Publications	10.26
			$105.38

The stubs corresponding to checks numbers 12062, 12064, and 12136 were properly completed by petitioner and the 1974 understatement will be reduced by $78.43. The understatement for 1974 will also be reduced by $16 to account for the fact that check number 11889 was used to purchase concert tickets for members of the Levy family. The 1974 understatement will be further reduced by $10.95 because check number 12061 was used to purchase an exercise wheel which Mr. Levy gave to a friend.

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(26) The following checks were drawn on the special account in 1975:

Check No.	Date	Payee	Amount
335	3/31/75	Forrest Theatre	$ 21.80
336	3/31/75	Fingerhut	23.96
427	5/12/75	Temple Music Fair	34.00
			$ 79.76

The stub corresponding to the check numbered 336 was properly completed and therefore we will reduce the 1975 understatement by $23.96. The 1975 understatement will be further reduced by $21.80 to account for check number 335 which was used to pay for theatre tickets for Mrs. Levy or their children. In addition, because check number 427 was used to pay for concert tickets purchased for members of the Levy Family, the 1975 understatement will also be reduced by $34.

B. Checks Drawn on the Special Account and Made Payable to "Cash"

Petitioner had a power of appointment granted by Mr. Levy which allowed her to sign checks on the special account. Petitioner and Mr. Levy were the only persons with authority to sign checks drawn on this account during the period in issue. Petitioner maintained the checkbook for the special account from January 1, 1973 to August 14, 1975. On many occasions, Mr. Levy would himself write out a check to "cash" and, if he was going to be out of town, he would sometimes take blank checks from the

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special account with him in case he needed cash while he was away. On other occasions, Mr. Levy would ask petitioner to make out the check, cash it and bring him the cash.

Though petitioner was not formally trained as a bookkeeper, she did take some accounting courses and she did manage several bank accounts for Mr. Levy. Formal sets of books were kept for all of the accounts except the special account. Records were not maintained for the special account because it was a personal account, used only to pay personal bills. All deductible expenses were paid out of the accounts for which books were kept. These books were reviewed on a regular basis by an accountant employed by the company for which Mr. Levy worked. There were no improprieties discovered in the books thus reviewed, but the accountant did not review the special account.

Janet Szlachta went through the records that were available with regard to the special account for the years in issue, and compiled a list of controversial checks that had been drawn by petitioner payable to cash. The criteria used by Janet to identify questionable checks were (i) that Mr. Levy was out of town when the check was cashed; (ii) that there was a discrepancy between a check and the corresponding stub, and/or (iii) that Mr. Levy had himself obtained cash by means of another check written on the same date. If any one of these circumstances existed with respect to a particular check, Janet noted that check on her

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list. Respondent included the amount of checks drawn on the special account to cash in the deficiencies for the years in issue on the same basis.

At trial, petitioner testified that differences in check and stub amounts and payees may have resulted from her practice of writing a batch of checks and filling in the stubs at a subsequent time. She said that she sometimes did not fill in the checkbook stubs at all, relying entirely on the bank statement for documentation. She said that when she wrote a check payable to cash she would sometimes make a notation on the line designated "payee," indicating who received the cash. We think that petitioner was too competent a bookkeeper to have been as consistently sloppy as she claims. On the other hand, we think that petitioner was capable of making some mistakes. Thus, if petitioner was able to provide this Court with a reasonable explanation of the circumstances surrounding the check in controversy, she will have sustained her burden of proof and we will reduce the understatement accordingly. With only one exception, petitioner has been unable to provide any such explanation.

Mr. Levy gave petitioner $500 to be used toward the purchase of a wedding gift. In November 1974, the month in which petitioner and Mr. Moskovitz were married, a check for $500, number 12263, was drawn on the special account payable to petitioner. This check, however, was signed by Mr. Levy and is consequently <u>not</u> one of the checks which form the basis for the

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deficiency for 1974 determined by respondent. In January 1975, however, another check for $500, number 156, was drawn on the special account payable to cash. This check was signed by petitioner, and does form part of the basis for the 1975 deficiency. Petitioner testified that she received the $500 from Mr. Levy as a gift to purchase some lamps. The words "lamps-Mary" are written on the stub which corresponds to check number 156, but neither the amount of the check nor the payee is accurately reflected on the stub. Check number 156 therefore, will remain part of the 1975 understatement.

The stub corresponding to check number 11875 reads "Meyers" and the amount shown is $7. Check number 11875 however, was made payable to "cash" in the amount of $700. Mr. Levy testified that Rickey Meyers was a friend to whom he might well have given $700. We will reduce the understatement for 1974 accordingly.

Check numbers 454 and 513 both cleared to cash for $1,500. The stubs corresponding to these checks both indicate that they were payable to "traffic court" in the amount of $15.[16] Petitioner testified at trial that cash in the amount of $1,500 was obtained with both these checks and paid (presumably as bribes) to the Chief Judge of the Philadelphia Traffic Court. Petitioner claimed that Mr. Levy instructed her to disguise these payments by writing "$15" on the check stubs in question. Of

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16 We note that petitioner pled guilty to four counts of forgery in a Pennsylvania court with regard to four checks totaling $5,000. Check number 513, discussed above, was one of these four checks.

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course, Mr. Levy has denied all this, and we will dismiss this explanation because it involves petitioner's unsupported and self-serving allegations of wrongdoing.

Thus, with only one exception (check number 11875), petitioner has failed to sustain her burden of proof with regard to these checks and no reduction in the 1973, 1974, or 1975 understatement will be afforded. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933). Those checks payable to cash totaling $14,740, $12,765, and $15,900 will therefore remain a part of the understatements as determined for the 1973, 1974, and 1975 taxable years, respectively.

Statute of Limitations--Section 6501

Section 6501(e)(1)(A) provides an exception to the normal 3-year statute of limitations where a taxpayer omits properly includable income from his return in an amount that exceeds 25 percent of the amount of gross income stated on the return.[17] In

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17 Section 6501(e)(1)(A) provides as follows:

(e) Substantial Omission of Items.--Except as otherwise provided in subsection (c)--
(1) Income Taxes.--In the case of any tax imposed by subtitle A--
(A) General Rule.--If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph--
(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or

(footnote continued)

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such a case, the generally applicable 3-year limitations period is extended to 6 years.

In order to invoke the 6-year statute of limitations pursuant to section 6501(e)(1)(A), respondent has the burden of proving the requisite omission. Bardwell v. Commissioner, 38 T.C. 84 (1962), affd. 318 F.2d 786 (10th Cir. 1963); Seltzer v. Commissioner, 21 T.C. 398 (1953); Reis v. Commissioner, 1 T.C. 9 (1942), affd. 142 F.2d 900 (6th Cir. 1944). Respondent may meet this burden of proof only by affirmative evidence. The presumption of correctness that normally attaches to respondent's deficiency determinations may not be relied upon in this regard. Reis v. Commissioner, supra.

Respondent has, in the instant case, offered affirmative evidence that does, even in the absence of the presumption of correctness, establish by a preponderance of the evidence that petitioners failed to report properly includable income on their return in an amount in excess of 25 percent of the amount of gross income stated on their returns. As discussed above, the

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(footnote continued from previous page)

services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the nature and amount of such item.

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checks which form the basis for the deficiencies determined in this case fall into two broad categories: (1) checks made payable to third parties, and (2) checks made payable to "cash."

The checks made payable to "cash" have been called into question because either (a) the check and the corresponding checkbook stub do not match; (b) Mr. Levy was out of town on the date on which the check was drawn; or (c) Mr. Levy obtained cash by another check, which he himself signed on the same date. We accepted each of these criteria as being indicative of embezzlement. On only one occasion, regarding a check in the amount of $700, was petitioner able to provide this Court with a satisfactory explanation.

Petitioners' gross income for the 3 years in issue, as stated on their returns was as follows:

Taxable Year Ending	Gross Income
December 31, 1973	$ 11,175.81
December 31, 1974	20,608.00
December 31, 1975	21,004.00

The proceeds of the checks payable to "cash" totaled $14,740, $12,765,[18] and $15,900 for the 1973, 1974, and the 1975 taxable years, respectively. Because these omitted amounts clearly exceed 25 percent of the stated amounts in each year, the 6-year statute of limitations of section 6501(e)(1)(A) applies.

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18 This amount excludes check number 11875 in the amount of $700 as that check was removed from the understatement.

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Therefore, assessment of taxes due for 1973, 1974, and 1975 would have been timely pursuant to section 6501(e)(1)(A) through April 16, 1980, April 16, 1981, and April 16, 1982, respectively.[19]

The statutory notice of deficiency for each of the disputed taxable years was duly mailed on December 3, 1981. This notice is clearly timely with regard to the 6-year statute of limitations applicable to the return for the taxable year 1975.[20] However, it is beyond the 6-year expiration date which applied to petitioners' 1973 and 1974 tax returns. Respondent is

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Under sec. 6501(b)(1), a return filed before the last day prescribed for filing is considered as filed on such last day. Thus, petitioner's timely filed 1973 return is deemed filed on April 15, 1974 and petitioners' timely filed 1974 and 1975 returns are deemed filed on April 15, 1975 and April 15, 1976, respectively.

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We note that there is a dispute between the parties as to whether the Forms 872 for 1975 were conditioned upon the applicability of the 6-year statute of limitations. Because respondent has proven the applicability of sec. 6501(e)(1), the period of assessment for 1975 continued through April 15, 1982, well after the date on which respondent mailed the statutory notice of deficiency for that year. Thus, whether the Forms 872 were conditioned on the applicability of the 6-year statute is of no import.

In addition, following the trial of this case, respondent filed an answer to Petitioners' Amended Petition addressing the issue of the applicability of the 6-year statute of limitations for 1975. Petitioners argue that because this issue was raised at trial it is a "new matter" upon which respondent has the burden of proof under Rule 142(a). We disagree. Petitioners raised the statute of limitations for 1975 for the first time in their "Motion for Leave to Amend Petition" served on respondent on June 6, 1983. Respondent's answer to Petitioners' Amended Petition merely replied to this affirmative allegation by setting forth the assertion that the notice of deficiency was timely under sec. 6501(c)(4). This does not constitute a "new matter" for purposes of Rule 142(a). Moreover, respondent bears the burden of proving the requisite omission when relying on the sec. 6501(e) 6-year statute of limitations.

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nevertheless not barred from assessing the deficiencies for the 1973 and 1974 taxable years by mailing the notice of deficiency on December 3, 1981.

On September 15, 1979 and June 15, 1980, petitioner executed forms 872 consenting to extensions of the statute of limitations with regard to her 1973 Federal income tax return to December 31, 1980 and December 31, 1981, respectively. In both instances, petitioner's consent was expressly conditioned on the applicability of the 6-year statute of limitations under section 6501(e)(1)(A). On June 15, 1980, petitioner and Mr. Moskovitz executed a Form 872 consenting to an extension with regard to their 1974 joint return to December 31, 1981. Petitioners' consent for 1974 was also expressly conditioned on the applicability of the 6-year statute. Therefore, these agreements serve to extend the otherwise applicable 6-year statute of limitations applicable to the 1973 and 1974 taxable years. We hold that the notice of deficiency was timely mailed to petitioners with regard to all 3 of the taxable years in issue.

Innocent Spouse Provision--Section 6013(e)

Petitioners have sought to qualify Mr. Moskovitz for relief from liability under the innocent spouse provision found in section 6013(e). According to respondent, section 6013(e) is not

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applicable to relieve Mr. Moskovitz of joint and several liability for the deficiencies and additions to tax resulting from petitioners' underreporting of taxable income.[21]

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21 Sec. 6013(e), as amended by the Tax Reform Act of 1984, Pub. L. 98-369, sec. 424(a), 98 Stat. 494, 801, provides, in pertinent part, as follows:

> (e) Spouse Relieved of Liability in Certain Cases.--
> (1) In general.--Under regulations prescribed by the Secretary, if--
> (A) a joint return has been made under this section for a taxable year,
> (B) on such return there is substantial understatement of tax attributable to grossly erroneous items of one spouse,
> (C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and
> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatement,
> then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.
> (2) Grossly erroneous items.--For purposes of this subsection, the term "grossly erroneous items" means, with respect to any spouse--
> (A) any item of gross income attributable to such spouse which is omitted from gross income, and
> (B) any claim of a deduction, credit, or basis by such spouse in an amount for which there is no basis in fact or law.
> (3) Substantial understatement.--For purposes of this subsection, the term "substantial understatement" means any understatement (as defined in section 6661(b)(2)(A) which exceeds $500. * * *
> [The amendments in sec. 6013(e) made by the Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 494 were made applicable to all cases pending at the time of their enactment.]

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Petitioners have the burden of proving that all four of the statutory prerequisites for relief pursuant to section 6013(e) have been satisfied. Rule 142(a); Sonnenborn v. Commissioner, 57 T.C. 373, 380-381 (1971).

The first requirement of section 6013(e) is that a joint return must be made for each of the taxable years in issue. Section 6013(e)(1)(A). In the instant case, the parties both agree that petitioners filed joint Federal income tax returns in 1974 and 1975, but not in 1973. Respondent contends, however, that petitioners have failed to satisfy the remaining requirements of section 6013(e) insofar as 1974 and 1975 are concerned.

In order to be relieved of liability, there must be a "substantial understatement of tax attributable to grossly erroneous items of one spouse." Section 6013(e)(1)(B).[22] Section 6013(e)(2) defines the term "grossly erroneous items" to include, with respect to any spouse "any item of gross income attributable to such spouse which is omitted from gross income." Based on the record as a whole, we are satisfied that petitioner had exclusive control over her embezzlement activities which constitutes the source of the unreported income in the instant case. Accordingly, we conclude that because the omitted

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22 A "substantial understatement" is defined in sec. 6013(e)(3) as any "understatement" which exceeds $500. Sec. 6661(b)(2)(A) defines an "understatement" as the excess of the amount of tax required to be shown on the return for the taxable year over the amount of tax imposed which is shown on the return, reduced by any rebate.

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income created an understatement of tax in excess of $500, petitioners have satisfied the requirements of section 6013(e)(1)(B).

Petitioners must next satisfy the third element of section 6013(e) which requires that the spouse seeking relief under this provision establish that "in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement." Section 6013(e)(1)(C). In order for petitioners to satisfy petitioners' burden of proof with respect to whether he had reason to know of the omitted income, Mr. Moskovitz "must establish that a reasonably prudent taxpayer, with * * * [his] knowledge of the family finances, would have no reason to know of the omission." Estate of Jackson v. Commissioner, 72 T.C. 356, 361 (1979). For the following reasons, we do not believe that Mr. Moskovitz knew or had reason to know that there was a substantial understatement for each of the years in issue.

Although Mr. Moskovitz was married to petitioner during 2 of the 3 years in issue, we do not believe that he had any actual knowledge of these substantial understatements. Respondent argues that Mr. Moskovitz learned that there was a question regarding petitioner's handling of the Levy special account involving possible forgery charges when a summons was delivered to his home in March of 1976, well before the due date for filing of the 1975 tax return. We note, however, that the evidence

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indicates that Mr. Moskovitz signed the 1975 joint income tax return in January of 1976, at least 6 to 8 weeks prior to the time that the summons was delivered.

In determining whether a spouse had reason to know of an understatement, this Court views as significant that spouse's degree of participation in business affairs or bookkeeping. Quinn v. Commissioner, 62 T.C. 223 (1974), affd. 524 F.2d 617 (7th Cir. 1975). We believe Mr. Moskovitz's uncontradicted testimony that he did not handle the family finances, check books, or bank accounts and that there had been no disclosure to him of unreported additional income. We believe Mr. Moskovitz's uncontradicted testimony that he turned over his salary checks to petitioner and received only a cash allowance from her. In addition, petitioner maintained possession of most of petitioners' credit cards. Furthermore, the bills that came in were given directly to petitioner and often Mr. Moskovitz would not even see them. Petitioner also made all bank deposits herself and reconciled all of the couple's bank statements.

Another factor significant in determining whether a spouse had reason to know of the omissions in income is the existence of unusual or lavish expenditures during the years in issue. Mysse v. Commissioner, 57 T.C. 680, 699 (1972). Although there were purchases made during the years in issue that were unusual in nature, Mr. Moskovitz explained how these purchases were arranged. For instance, petitioners purchased a home in 1974 about 1 month before they were married. According to Mr.

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Moskovitz, petitioner's father lent them the money used to purchase the home and he holds the mortgage on it. In addition, petitioners went on a honeymoon in Acapulco for a week after they were married. The trip was paid for with funds from Mr. Moskovitz's personal savings. Finally, although Mr. Moskovitz admits that he purchased a new automobile in 1974, the car was paid for by trading in his own car and with long-term financing. Thus, we find that the purchases noted above, although admittedly out of the ordinary, were not financed with the funds embezzled by petitioner and therefore we do not find these purchases to be significant in deciding whether Mr. Moskovitz had reason to know of the omissions from gross income.

It is obvious that Mr. Moskovitz totally relied on his wife to handle the family finances. Petitioner has accounting and bookkeeping experience and expertise, and was, in fact, presumed by Mr. Moskovitz to have properly completed the tax returns in question. The requirement of section 6013(e)(1)(C) that Mr. Moskovitz neither knew or had reason to know of the omission is therefore satisfied.

We must now ascertain whether "taking into account all the facts and circumstances, it is inequitable to hold * * * [Mr. Moskovitz] liable for the deficiency in tax." Section 6013(e)(1)(D). Although no longer a specific requirement of section 6013(e)(1), whether Mr. Moskovitz benefited from the

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substantial understatements of income is still a factor to be considered in making this determination. See H. Rept. 98-432 (Part 2) 1501, 1502 (March 5, 1984).[23]

We conclude, for the reasons that follow that it would be inequitable to impose liability upon Mr. Moskovitz. The term "inequitable" is defined under section 1.6013-5(b), Income Tax Regs., as follows:[24]

> Whether it is inequitable to hold a person liable for the deficiency in tax * * * is to be determined on the basis of all the facts and circumstances. In making such a determination a factor to be considered is whether the person seeking relief significantly benefited, directly or indirectly, from the items omitted from gross income. However, normal support is not a significant "benefit" for purposes of this determination. * * * [Emphasis added.]

Respondent contends that Mr. Moskovitz received significant benefits from the income omitted from petitioners' 1974 and 1975 tax returns. We disagree. We are convinced from Mr. Moskovitz's uncontradicted testimony that he did not benefit in any significant manner from the money that petitioner embezzled from her employer during the years at issue. In addition, he did not receive any extraordinary gifts from his wife during this period.

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23 Prior to its 1984 amendment, sec. 6013(e)(1)(C) specifically required that we make our determination as to whether it is inequitable to hold the "innocent spouse" liable for the deficiency by "taking into account whether or not the other spouse significantly benefited directly or indirectly from the items omitted from gross income * * *."

24 We note that sec. 1.6013-5(b), Income Tax Regs., was promulgated prior to the effective date of sec. 424(a) of the Tax Reform Act of 1984, Pub. L. 98-369, which removed the specific reference to a significant benefits determination.

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Furthermore, because petitioner had exclusive control over the family finances, she was able to pay her creditors and otherwise make use of the ill-gotten funds in any way she chose. Indeed, we believe that the benefits, if any, received by Mr. Moskovitz as a result of the unreported income were in the nature of ordinary family support, which is not a sufficient basis to support a finding of significant benefit. Terzian v. Commissioner, 72 T.C. 1164, 1172, 1173 (1979); Mysse v. Commissioner, 57 T.C. 680, 698, 699 (1972). Furthermore, the recent amendments to section 6013(e) denote a liberalization of the innocent spouse provisions. See H. Rept. 98-432 (Part 2), supra at 1502. In light of these statutory changes, we do not believe that the incidental benefits enjoyed by Mr. Moskovitz are sufficient to make it equitable to impose liability in the instant case. We therefore conclude that petitioners have sustained their burden of proving Mr. Moskovitz entitled to the benefits afforded to an innocent spouse pursuant to section 6013(e).

Section 6653(a) Addition to Tax

The next and final issue is whether petitioners' underpayment of tax for the 3 years in issue was due to negligence or intentional disregard of rules and regulations pursuant to section 6653(a). Petitioner has the burden of proving that she is not liable for this addition to tax. Enoch v. Commissioner, 57 T.C. 781, 802-803 (1972); O'Donohue v. Commissioner, 33 T.C. 698 (1960).

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Petitioner, in the instant case, has failed to present any credible evidence to justify her failure to report these amounts as income on their returns or to rebut respondent's determination in the notice of deficiency. Petitioner argues on brief however, that she should not be liable for the section 6653(a) addition to tax due to her reliance upon her professional accountants who allegedly assisted petitioners in the preparation of their Federal income tax returns. We disagree. A taxpayer's reliance upon the advice of a tax return preparer cannot by itself absolve the taxpayer of responsibility for the correctness of his tax return.

As a general rule, the duty of filing an accurate tax return cannot be averted by shifting the responsibility to an agent. Pritchett v. Commissioner, 63 T.C. 149, 174 (1974). Enoch v. Commissioner, supra at 802-803. An exception to this rule is made if the taxpayer is able to establish that he furnished all of the relevant information. Pritchett v. Commissioner, supra at 174. Enoch v. Commissioner, supra at 802-803. At the very least, petitioner must establish that she provided the tax return preparer with the information necessary to correctly prepare their return. Pessin v. Commissioner, 59 T.C. 473, 489 (1972). Enoch v. Commissioner, supra at 802-803 (1972). Petitioners have made no such showing in the instant case.

It is clear that petitioner embezzled substantial sums of money from her employer during each of the taxable years in issue. It is also well-established that embezzled funds are

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includable in gross income. James v. United States, 366 U.S. 213 (1961). Petitioner produced no evidence to indicate that she furnished any information to her tax return preparer concerning her illegal activities and therefore we find in respondent's favor on this issue as to petitioner.[25]

Decision will be entered under Rule 155.

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25 See Trimmer v. Commissioner, T.C. Memo. 1983-131; Ross v. Commissioner, T.C. Memo. 1978-380.

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APPENDIX I

CHECKS DRAWN ON THE SPECIAL ACCOUNT PAYABLE TO THIRD PARTIES

(i.e., checks paid to one of petitioners' creditors)

	Check No.	Year	Amount	Payee
1)	10707 10771 10871 10935 10990 11074 11145 11214 11264 11326 11356 11446	1973	2,853.40 (Total)	These checks were credited to petitioner's account at Strawbridge & Clothier.
2)	11507 11584 11652 11720 11815 11880 11935 12042 12142 12316 12386	1974	1,580.35 (Total)	Same as above.
3)	138 432 531	1975	864.44 (Total)	Same as above.
4)	10989*[26] 11140* 11190 11262* 11321 11347 11433	1973	852.15 (Total)	These checks were credited to petitioner's charge account at Wanamaker's.

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26 Those checks designated by an asterisk (*) are checks a portion of the proceeds of which were used to purchase items for Mr. Levy or his family. Such amounts were removed from the understatement for the year involved.

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5)	10504 11581* 11651 11800* 11877 11936* 12025 12070 12141 12387	1974	1,781.68 (Total)	Same as above.
6)	147 278 523	1975	731.27 (Total)	Same as above.
7)	10766 10998 11084	1973	382.84 (Total)	These checks were credited to petitioner's Mastercharge account with the Provident National Bank.
8)	11577 11646 11802 11900 11989 12046 12103 12269 12397	1974	1,053.64 (Total)	Same as above. Check No. 12397 ($79.94) was credited to Mr. Moskovitz's Mastercharge acct.
9)	201	1975	248.06	This check was credited to Mr. Moskovitz's Mastercharge account.
10)	10998 11071 11189 11349	1973	178.86 (Total)	These checks were credited to petitioner's Bankamericard with the Philadelphia National Bank.
11)	11583 12027 12065 12315	1974	528.39 (Total)	Same as above.
12)	212 338 433	1975	592.05 (Total	These checks were credited to Mr. Moskovitz's Bank Americard account.
13)	11816 148 217	1974 1975 1975	135.52 61.52 31.79	These checks were credited to petitioner's charge account at Sears.

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14)	172 399	1975 1975	74.19 453.00	These checks were credited to Mr. Moskovitz's charge account at Sears.
15)	11420	1973	122.78	This check was credited to petitioner's charge account at the Bamberger's department store.
16)	11641 11820 11901 11986 12104	1974	570.57 (Total)	Same as above.
17)	11817 11985 12099	1974	859.00 (Total)	These checks were paid to petitioner's landlord, Friedman and Raph.
18)	11091 11295 11344	1973	186.14 (Total)	These checks were credited to petitioner's charge account at Bonwit Teller.
19)	11995	1974	93.00	Same as above.
20)	10853 11265	1973	132.01 (Total)	This check was to petitioner's account at Gimbel's.
21)	11502	1974	20.00	Same as above.
22)	11001 11199 11284 11425	1973	84.00 (Total)	These checks were made payable to Lintree Hosiery, a mail order company from which petitioner ordered hosiery for herself and other office employees. She collected money to cover the orders of the office employees directly from those persons.
23)	514	1975	263.88	This check was credited to petitioner's charge account at J.C. Penney's.
24)	10925	1973	309.30	This check was credited to petitioner's charge account at Hess's Department Store.

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25) 210	1975	155.80	Check number 210 was credited to Mr. Moskovitz's Chevron charge account. Petitioner testified that Mr. Levy let her use his car while he was away once, and she had to have it repaired while he was gone. Check number 210, she said, was payment for these repairs, authorized by Mr. Levy. Mr. Levy has denied lending petitioner his car, and she has failed to sustain her burden of proof with respect to this check. No reduction will be in the deficiency for the 1975 taxable year.

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APPENDIX II

CHECKS PAYABLE TO THIRD PARTIES WITH STUBS THAT INDICATE A PAYEE OR AMOUNT DIFFERENT FROM THAT INDICATED ON THE CORRESPONDING CHECK

1)	11934 11998 12116	1974	$62.02 (Total)	These checks were drawn on the special account payable to Current, Inc. a mail order company. None of the corresponding checkbook stubs indicate that Current, Inc. was the payee.
2)	11993	1974	35.50	This check was drawn on the special account payable to Frank Lewis Co., a mail order company; the stub corresponding to this check indicates a different payee.
3)	11006	1973	29.81	This check was made payable to The Country Gourmet. The corresponding stub does not match the check.
4)	11882 11921	1974	37.73 (Total)	Same as above.
5)	11286	1973	72.90	This check was payable to Figi's, a mail order company. The corresponding stub was not properly completed.
6)	223	1975	19.85	Same as above.
7)	11290	1973	14.21	This check was payable to Miles Kimball, a mail order company. The corresponding stub does not indicate the same payee.
8)	12044	1974	23.65	Same as above.
9)	502 509	1975	67.59 (Total)	Same as above.
10)	12112 135	1974	43.60 (Total)	These checks were payable to Joan Cook, a mail order company. The corresponding stubs do not match.
11)	425	1975	54.20	This check was payable to Joan Cook. The corresponding stub does not indicate any payee at all.
12)	11320 11335	1973	207.15 (Total)	These checks were payable to the Kenton Collection. Both of the corresponding check stubs indicate payees other than those shown on the checks in issue.

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13) 11282	1973	31.19	This check was payable to "Rich's." The corresponding stub indicates a different payee.
14) 12060	1974	26.03	This check was payable to J.C. Penney's. The corresponding stub indicates a different payee.
15) 12041	1974	135.25	This check was payable to Saks Fifth Avenue. The corresponding stub indicates a different payee.
16) 11212	1973	29.50	This check was payable to "Hattie Carnegie." The corresponding checkbook stub indicates a payee other than "Hattie Carnegie."
17) 11498	1974	60.00	This check was payable to "St. Hubert's Alumni." There is a different payee indicated on the corresponding checkbook stub.
18) 11992	1974	10.00	This check was payable to "Fosdick Corp." The corresponding stub indicates a different payee.
19) 12113	1974	17.89	This check was payable to "Harriet Carter." A different payee is indicated on the corresponding checkbook stub.
20) 11499	1974	56.20	This check was payable to "Barbara Corbin." The corresponding stub for this check does not indicate a payee.
21) 283	1975	31.15	This check was payable to "Jean Coren." The corresponding stub indicates a different payee.
22) 12146	1974	28.10	This check was payable to "Pepperidge Farm." The stub corresponding to this check does not indicate any payee.

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T. C. Memo. 1986-358

UNITED STATES TAX COURT

RODERICK C. HOAK AND CORNELIA HOAK, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

DOUGLAS F. ADDINGTON, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 11102-82, 26684-82. Filed August 6, 1986.

Arnold V. Plum, for the petitioners in docket No. 11102-82.

Dante G. Bertani (specially recognized), for the petitioner in docket No. 26684-82.

Edward J. Laubach, Jr., for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

SHIELDS, Judge: Respondent determined deficiencies in petitioners' income tax and additions to tax as follows:

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Petitioners	Year	Deficiency	Addition to Tax Section 6653(b)[1]
Roderick C. Hoak and Cornelia Hoak	1974	$ 50,116.89	$ 29,894.00
	1975	20,029.56	10,014.78
Douglas F. Addington	1974	211,720.00	122,102.00[2]

After concessions, the issues remaining for decision are:

(1) whether petitioners had unreported income as determined by respondent;

(2) whether petitioners Roderick C. Hoak and Douglas F. Addington are liable for additions to tax under section 6653(b); and

(3) whether the statute of limitations on assessment has expired with respect to petitioners Roderick C. and Cornelia Hoak for the taxable year 1974.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations and exhibits attached thereto are incorporated herein by reference.

Petitioners Roderick C. Hoak and Cornelia Hoak, husband and wife, resided in Elizabeth, Pennsylvania at the time of the filing of their petition. They reported their income and expenses

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1 All section references are to the Internal Revenue Code of 1954, as amended, during the years in issue unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure, unless otherwise provided.

2 On January 9, 1984, respondent was granted leave to file an amended answer with respect to Douglas Addington. This amended answer increased the deficiency to $286,560 and the addition to tax under section 6653(b) to the amount of $159,522.

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for 1974 and 1975 on the cash basis and filed joint income tax returns for such years with the Internal Revenue Service Center in Philadelphia. The 1974 return was filed on May 2, 1975 pursuant to a timely application for an extension of time for filing.

Petitioner Douglas F. Addington, resided in North Huntington, Pennsylvania at the time of the filing of his petition. He reported his income and expenses for 1974 on the cash basis and filed a return for such year as a single person with the same Service Center.

Mr. Hoak has been involved in salvage work since he was eight years old. His formal education ceased with the sixth grade. Mr. Addington has also been in the salvage business for many years. He is completely illiterate, being able to read and write only his name. From the record as a whole, however, it is apparent that in spite of his lack of an education Mr. Addington possesses an unusual ability for operating businesses.

Hoak and Addington first met in 1973. At that time, Hoak had a contract with Liberty Vehicle Leasing, Inc. (Liberty) to gather waste materials from a mill belonging to U.S. Steel. Addington had a dump and a permit under which waste materials could be dumped and any usable scrap metal could be removed therefrom. With Hoak's contract and Addington's dump and permit, they formed an informal partnership or joint venture known as D & H Steel Salvage Company (D & H). There was no written partnership agreement. Hoak and Addington merely agreed to share profits and losses from D & H on an equal basis.

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One of D & H's first transactions was to enter into a new contract with Liberty. Under the new contract and during 1974 and 1975 D & H collected all waste including slag from steel mills, and extracted from the waste any scrap metal. Liberty hauled the waste from the mills to the dump and any scrap from the dump to the place of its sale, collected the sale proceeds, deducted $2.00 per ton for hauling, kept 25 percent of the net proceeds, and distributed the remaining 75 percent of the proceeds to D & H.

In D & H's day to day operations Hoak supervised the dump and salvage operation while Addington maintained the partnership permits and arranged the sales of the scrap to various steel mills. For about four or five months, part of which was in 1974 and part in 1975, Addington was sick and unable to work. During this period his duties were performed by an employee of D & H.

For the calendar years 1974 and 1975 D & H filed partnership returns on the cash basis with the Philadelphia Service Center. The returns reflected gross receipts for 1974 and 1975 in the respective amounts of $607,818.00 and $314,083.95.

All parties agree that on the return for 1974 the gross receipts of D & H were understated by $210,909.97. The understatement is represented by sales made to Monongahela Iron and Metal Company, Essex Steel Corporation, Allegheny Sand, and Josh Steel in the amounts shown below:

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Monongahela Iron & Metal Company	$203,613.64
Essex Steel Corporation	258.89
Allegheny Sand	5,276.94
Josh Steel	1,760.50
TOTAL	$210,909.97

In addition to the agreed omissions set forth above, we also find that during 1974 Monongahela received, issued weighbills, and paid D & H for scrap on nine different occasions in the total amount of $30,624.46. These receipts were also omitted on D & H's 1974 return. Consequently, the gross receipts of D & H for 1974 were understated by a total of $241,534.43 before any adjustment for an overstatement of $2,163.05 which respondent concedes was made by D & H in its reported receipts. With this adjustment, the net understatement of D & H's gross receipts for 1974 is $239,371.38. Under the agreement between Hoak and Addington, one-half of the understatement is attributable to Hoak and one-half is attributable to Addington.

The omitted 1974 receipts from Monongahela, totaling $234,238.10, were represented by 72 separate sales of scrap. At the request of both Hoak and Addington these sales were paid for by Monongahela in cash. One of the cash payments was received by Hoak alone, 61 payments were received by Addington alone, and one was received by both Hoak and Addington. The record fails to disclose who received the other 9 payments, but Carol Mika, the bookkeeper for D & H, testified that she picked up some payments from Monongahela. All of the cash payments were made on the premises of Monongahela and were carried by the recipient to the office of D & H which was located in Doug's Motel where the cash

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was divided equally between Hoak and Addington, sometimes in the presence of Carol Mika, the bookkeeper of D & H, and/or Ruth Humphrey, another employee of D & H.

D & H's records for 1975 were destroyed before respondent commenced his audit of that year.[3] However, respondent's agents were able to reconstruct the 1975 receipts in the following manner. First, from the cancelled checks of third parties respondent was able to establish and the parties have stipulated that D & H had gross receipts in 1975 paid by checks in the total amount of $238,040.32. Secondly, from 18 written receipts signed by Addington for cash sales made by D & H to Monongahela, it was established and stipulated to by the parties that D & H had gross receipts paid by cash during 1975 from Monongahela which totaled $64,038.41. All of these cash payments were picked up by Addington. Finally, respondent noted that on the 1975 return D & H had deducted $61,940.00 from its $314,083.95 in reported gross receipts for the amount retained by Liberty under its agreement with D & H. Since it is agreed that D & H followed the practice of including in receipts the total amount collected by Liberty and then deducting out the 25 percent retained by Liberty as a commission or other expense, respondent added the $61,940.00 to the sales by check of $238,040.32 and the cash sales of $64,038.41 in order to arrive at corrected gross receipts in the amount of $364,018.73. In this manner respondent correctly concluded that the gross receipts for 1975 were understated by at

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[3] The record does not disclose how, why, or by whom the records were destroyed.

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least $49,934.78 ($364,018.73 - $314,083.95). Under the original agreement between Hoak and Addington one-half of the understatement is attributable to Hoak and one-half to Addington.

Hoak's Unreported Income

During 1975 Hoak sold scrap metal to Dart Cartage Company for $12,533.74. In payment for the scrap, Hoak received a check dated November 20, 1975 from Dart Cartage. The check was cashed or otherwise negotiated by Hoak on or before December 8, 1975. Although the check represented income to Hoak, it was not reported on his 1975 return.

Addington's Unreported Income

In addition to being a partner in D & H, Addington owned and operated three other businesses during 1974--Doug's Construction, Doug's Motel, and Doug's Steel and Salvage Company (Doug's Steel). It is agreed that the gross receipts of two of these businesses, Doug's Steel and Doug's Construction, were understated on Addington's 1974 return by the respective amounts of $84,471.50 and $126,779.39. Respondent concedes, however, that Addington is entitled to adjustments for bookkeeping errors in reporting the gross receipts of Doug's Steel and Doug's Construction in the amounts of $400.00 and $4,925.95, respectively.

Carol Mika, the bookkeeper for D & H, prepared its partnership returns for 1974 and 1975. She went over each return with both Hoak and Addington.

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Carol Mika also prepared Addington's 1974 individual return and went over it with him. She also prepared the joint returns for Mr. and Mrs. Hoak for 1974 and 1975. She went over these returns with Hoak. At the time these returns were prepared and at the time she discussed them with Hoak and Addington, Carol Mika knew that the receipts for the cash sales made to Monongahela for D & H for both 1974 and 1975 were not reported on either the partnership or the individual returns. The omissions, however, were not mentioned by Mika, Hoak or Addington.

On November 20, 1981, Addington pleaded guilty in the United States District Court for the Western District of Pennsylvania to willfully and knowingly attempting to evade and defeat a large part of the income tax due and owing by him for 1974 by filing a false and fraudulent income tax return in violation of section 7201.

On March 30, 1982 respondent mailed a statutory notice to Mr. and Mrs. Hoak in which he set forth his determination of the deficiencies and additions to tax with respect to their 1974 and 1975 tax returns. On August 11, 1982, respondent mailed a statutory notice to Addington in which he set forth his determination with respect to Addington's income tax return for 1974.

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OPINION

Unreported Income of D & H

Hoak insists that he should not be charged with 50 percent of D & H's cash receipts from Monongahela. In support of this contention he points to the uncontroverted fact that all of the cash receipts in 1975 and almost all of them in 1974 were picked up at Monongahela by Addington and insists that Addington only gave him between $10,000 and $15,000 of such receipts. Hoak also testified that he had no way of knowing in 1974 and 1975 the full extent of the sales to Monongahela or the amount of Monongahela's cash payments and therefore he did not know at that time how large his one-half interest in the payments was after subtracting the hauling charges and Liberty's 25 percent.

The record, however, contains no evidence which tends to corroborate Hoak's testimony on this point. On the contrary, the record contains a great deal of evidence which tends to refute it. For instance, Harold Rice and James Sproul were employed in 1974 and 1975 by Addington as truck divers. They testified that they hauled scrap from D & H's dump to Monongahela on a regular basis, that Hoak often directed them to make the deliveries, and that Hoak frequently asked to see the weighbills that they received from Monongahela. Carol Mika, the bookkeeper for D & H, testified that in 1974 and 1975 she gave Hoak weekly reports of D & H's receipts, that on a few occasions she counted and divided the cash payments between Hoak and Addington, and that on several occasions she observed Hoak and Addington dividing the cash between themselves. Ruth Humphrey, another employee of D & H,

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testified that she had also observed Hoak and Addington dividing the cash payments in 1974 and 1975 and that she was hired by Hoak to make copies of the Monongahela weighbills and to deliver them to him weekly. Addington testified that usually Hoak accompanied him to Monongahela to pick up the cash payments and if he did not, they would get together at Doug's Motel immediately after the payments were picked up and the cash would be divided in accordance with the terms of the partnership agreement. Furthermore, Hoak himself testified that during 1974 and 1975 he was in charge of the salvaging process, kept account of the scrap metal recovered at the dump, and saw the weighbills for the sales of the scrap. We are satisfied therefore from the record as a whole that Hoak knew generally, if not specifically, the extent of the scrap material being hauled to Monongahela and the amount that Monongahela was paying for it. We are also satisfied that all, or substantially all, of the cash payments were received and divided in the manner testified to by the other witnesses.

In any event, we are dealing with the profits of D & H which is admittedly a partnership for tax purposes and each partner in a partnership is taxable on his distributive share of the partnership's income whether or not his distributive share is actually distributed. See United States v. Basye, 411 U.S. 483 (1973). In fact the retention of partnership profits by one partner does not relieve the other partner from including his distributive share of the partnership income in his gross income for the year earned by the partnership. See Commissioner v. Golberger's Estate, 213 F.2d 78 (3d Cir. 1954); United States v.

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Baker, 233 F.2d 195 (10th Cir. 1956). Consequently, Hoak's contention is inapposite because under the circumstances of this case it does not matter whether he actually received his share of the cash receipts so long as such receipts were includable in D & H's partnership earnings for 1974 and 1975 as the parties have stipulated.

Both Hoak and Addington contend that D & H is entitled to deduct from the cash received from Monongahela the 25 percent due to Liberty for hauling. However, their testimony that cash equal to 25 percent of each payment received by D & H from Monongahela was paid to Liberty is not supported by the record as a whole and especially by the testimony of Mr. Picone, the principal officer of Liberty, who stated that only two cash payments were ever made to him or his company. Respondent's agent also testified that he could find no evidence of any other such payments being made to Liberty or to Mr. Picone.

Consequently on this record we are unable to find that 25 percent of the cash receipts of D & H were paid over to Liberty. We conclude therefore that respondent's computation of the unreported income of D & H for both 1974 and 1975 is correct and that 50 percent of such unreported income is attributable to Hoak and 50 percent to Addington.

Fraud

With respect to this issue we note at the outset that Addington pleaded guilty to having filed a false and fraudulent return for 1974 in violation of section 7201. This plea alone is

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sufficient to collaterally estop him from denying that he is liable for the addition to tax for 1974 provided by section 6653(b). Gray v. Commissioner, 708 F.2d 243 (6th Cir. 1983), affg. a Memorandum Opinion of this Court, cert. denied 466 U.S. 927 (1984); Plunkett v. Commissioner, 465 F.2d 299 (7th Cir. 1972), affg. a Memorandum Opinion of this Court; Strachan v. Commissioner, 48 T.C. 335 (1967); Amos v. Commissioner, 43 T.C. 50 (1964), affd. 360 F.2d 358 (4th Cir. 1965).

Respondent, however, has the burden of proving by clear and convincing evidence that some part of the underpayment of Hoak for each of the years was due to fraud. Section 7454(a); Rule 142(b). This burden is met if it is shown that Hoak intended to conceal, mislead, or otherwise prevent the collection of a tax known to be due. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968), cert. denied 393 U.S. 1020 (1969); Webb v. Commissioner, 394 F.2d 366 (5th Cir. 1968), affg. a Memorandum Opinion of this Court; Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983).

The presence or absence of fraud is a question of fact to be determined from the entire record. Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Fraud is never presumed but must be established by affirmative evidence. Beaver v. Commissioner, 55 T.C. 85 (1970). It may, however, be proven by circumstantial evidence because direct proof of a taxpayer's intent is never readily available. The taxpayer's entire course of conduct may

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be examined to determine whether the fraudulent intent is present. Stone v. Commissioner, 56 T.C. 213, 223-224 (1971); Otsuki v. Commissioner, 53 T.C. 96, 105-106 (1969).

A review of the record in this case clearly and convincingly establishes that:

(1) D & H made numerous sales of scrap to Monongahela in 1974 and 1975;

(2) Both Roderick C. Hoak and Douglas Addington requested that Monongahela pay cash for the scrap;

(3) Monongahela's cash payments to D & H in 1974 and 1975 were not reported on D & H's partnership returns;

(4) Both Hoak and Addington knew that the cash payments were taxable;

(5) Both Hoak and Addington knew that the Monongahela payments were excluded from D & H's 1974 and 1975 partnership returns and from their personal returns;

(6) Hoak failed to report on his 1975 return $12,533.74 he received during 1975 from the sale of scrap metal to Dart Cartage Company. Addington failed to report on his 1974 return gross receipts of two of his businesses, Doug's Steel and Doug's Construction, in the amounts of $84,471.50 and $126,779.39, respectively; and

(7) Hoak fraudulently omitted taxable income from his returns for 1974 and 1975. Addington fraudulently omitted taxable income from his return for 1974. Consequently, both Hoak and Addington are liable for additions to tax under section 6653(b) as determined by respondent.

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Statute of Limitations

Since a part of Hoak's income for 1974 was fraudulently omitted from the 1974 return an assessment for 1974 is not barred by the statute of limitations because the assessment can be made at any time under section 6501(c)(1). Benn v. Commissioner, T.C. Memo. 1963-151, affd. 366 F.2d 778 (5th Cir. 1966), cert. denied 389 U.S. 833 (1967).

To reflect the foregoing, as well as concessions made by the parties,

Decisions will be entered under Rule 155.

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T. C. Memo. 1986-359

UNITED STATES TAX COURT

FRANCIS S. PIEKARCZYK, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 734-84. Filed August 7, 1986.

Francis S. Piekarczyk, pro se.

Teri A. Frank, for the respondent.

MEMORANDUM FINDINGS OF
FACT AND OPINION

KORNER, Judge: For the calendar year 1980, respondent determined a deficiency of income tax against petitioner in the amount of $1,197, together with additions to tax under sections 6651(a) and 6653(a),[1] in the respective amounts of $299.25 and $79.85. After concessions on both sides, the sole issue for our

[1] All statutory references are to the Internal Revenue Code of 1954, as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

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determination is whether petitioner suffered a deductible loss in 1980 on account of the alleged worthlessness of certain stock owned by him.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

At the time the petition herein was filed, petitioner was a resident of Chicago, Illinois. Petitioner's individual income tax return for the calendar year 1980 was received by respondent's Kansas City Service Center on September 11, 1981. Petitioner thereafter filed an amended return on Form 1040 X for 1980, received by respondent's Kansas City Service Center on December 24, 1981, in which petitioner claimed a long-term capital loss of $19,688 with respect to 126 shares of stock in Lansing Air Charter, Inc., which petitioner alleged he owned and which became worthless in 1980. In his petition herein, such amount was increased to $23,000.

Lansing Air Charter, Inc. ("Lansing") was incorporated in Illinois on April 20, 1978. It was involuntarily dissolved on December 1, 1980 by the State of Illinois for failure to file its annual report and pay taxes. For some undisclosed time during this period, Lansing did business under the name "Eagle Air" or "Eagle Transport." From about December 1, 1978 until December 1979, Lansing conducted business at the Lansing, Illinois,

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Municipal Airport, under a "temporary commercial operating agreement" entered into between Lansing and the Village of Lansing, Illinois. On December 9, 1979, the Village of Lansing terminated this temporary operating agreement, and Lansing conducted no business thereafter.

Eagle Air, Inc., was incorporated in Illinois on November 28, 1979. It was involuntarily dissolved on December 1, 1980, for failure to file its annual report and pay taxes. The record herein does not disclose who the stockholders of Eagle Air, Inc. were, nor that it ever transacted any business.

Robert J. Doll ("Doll") was a man who, for several years prior to 1978, had been employed by an aircraft dealership in the area of Lansing, Illinois. In 1976, petitioner purchased through Doll a Grumman American Cheetah airplane, and also purchased some radio and navigation equipment for the plane. Petitioner sold this airplane in 1978, and reported in his 1978 income tax return a loss therefrom in the amount of $727.

At some time after 1976 and prior to 1978, the airplane dealership for which Doll worked apparently failed. Doll approached petitioner and represented to him that there was a business opportunity for another small aircraft dealership in the Lansing, Illinois area, and sought petitioner's assistance in putting such an enterprise together. Additionally, Doll was negotiating with at least two other persons in the area as potential partners or investors in the new aircraft dealership. Apparently even prior to the formation of Lansing in April 1978,

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there were various financial transactions between petitioner and Doll. The record is not clear whether these transactions were purchases of equipment from Doll by petitioner, loans from petitioner to Doll, or investments in the proposed new enterprise which had not yet been incorporated. After its incorporation, Lansing, d/b/a Eagle Air, was very loosely operated, but appears to have been under the effective control of Doll at all times.

In the period 1978-1979, petitioner made payments by check to Doll, Lansing and/or Eagle Air as follows:

Date of Check	Amount	Payee	Purpose of Payment Stated on Check
Dec. 27, 1978	$1,500.00	Robt. J. Doll	----
Jan. 10, 1979	1,045.00	Lansing Air	----
Jan. 16, 1979	400.00	Eagle Air/ Lansing Air	RG ----2/
Jan. 15, 1979	100.00	Lansing Air/ Eagle Air	Equity RGII
March 8, 1979	1,000.00	Eagle Air	ADF gear [balance illegible]3/
June 3, 1979	1,250.00	Lansing Air Charter	----
Aug. 23, 1979	1,191.00	Lansing Air Charter	----
Aug. 28, 1979	1,000.00	Eagle Air	----
Sept. 12, 1979	1,600.00	Eagle Air	----
July 13, 1979	1,599.32	F.S. Piekarczyk/ Lansing Air Charter d/b/a Eagle Air	re: N2055E4/
Total	$10,685.32		

2/ The references to "RG" or "RGII" relate to a Cessna Skylane RGII aircraft.

3/ The reference is to automatic direction finder equipment for an aircraft.

4/ Refers to purchase of an aircraft. See infra herein.

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In June 1979, petitioner purchased from Lansing a 1979 Cessna Skyhawk Model 172 airplane, whose identification number was N2055E. At that time, the retail list price of such an airplane, including the optional equipment with which this plane was equipped, was in the neighborhood of $35,000.

Although this Cessna airplane was a new plane which Lansing had for sale as a distributor of Cessna, it had been damaged, and petitioner purchased it for less than the retail list price. Petitioner secured a loan from the Beverly Bank of Chicago, in the total amount of $35,824.80. Of this amount, $24,900.68 was paid to the Cessna Finance Corporation through a bank in Wichita, Kansas, and $1,599.32 (shown in our listing above), was paid to Lansing Air, for a total purchase price of $26,500.

At the time the Cessna aircraft was damaged (prior to petitioner's purchase), it was insured against accidental damage. Pursuant to a damage claim made by Lansing Air, the insurers paid Lansing Air $8,809 (after a $500 deductible) on account of this accidental damage.

OPINION

Petitioner claims that he experienced a long-term capital loss in the year 1980 on account of the alleged fact that 126 shares of Lansing which he owned became worthless in that year. Such a loss, if proved, would be allowable under the provisions of

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section 165(g).5/ The amount of such loss is the taxpayer's cost basis, as provided in section 1011. In order to qualify for the claimed deduction, it must be established (a) that the taxpayer was the owner of such stock; (b) the taxpayer's cost basis therein; and (c) that the stock became worthless in the taxable year in question. The burden of proof as to all these matters was upon petitioner. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Upon this record, we must hold that petitioner has failed to carry his necessary burden of proof to show that he was either the owner of any stock in Lansing, or, if he was, his cost basis in such stock.

As to the fact of petitioner's ownership of any stock in Lansing, the record is singularly deficient. Aside from a self-serving document, executed by petitioner and others, stating that petitioner was the owner of 25 percent of the outstanding shares of Lansing, which document was executed for unknown purposes

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5/ As herein relevant, sec. 165(g) provides as follows:

> (g) Worthless securities.--
>
> (1) General Rule.--If any security which is a capital asset become worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.
>
> (2) Security defined.--For purposes of this subsection, the term "security" means--
>
> (A) A share of stock in a corporation;
>
> * * *.

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sometime in the year 1979, we have only petitioner's vague and rambling testimony on the point. No corporate records evidencing petitioner's ownership were produced, nor were any stock certificates in petitioner's name offered in evidence. No other witness appeared at trial to corroborate petitioner's claim of ownership. Cf. Nickoll v. Commissioner, 103 F.2d 619 (7th Cir. 1939); Allen v. Commissioner, T.C. Memo. 1967-105.

So far as petitioner's alleged equity investment in Lansing is concerned, which could serve as a cost basis for his claimed shares, the record is equally inconclusive. It is unquestioned that there were a multiplicity of transactions between petitioner, on the one hand, and/or Doll and Lansing on the other hand. The money transfers from petitioner are detailed in our findings of fact. Petitioner claims that they all represented equity investment by him in the stock of Lansing, made at various times and in various amounts during the period of Lansing's existence. Close examination of the transfers, however, fails to support this contention.

With respect to the payments of $400, $100, $1,000, and $1,599.32, it is clear that the latter payment was part of the purchase price of the Cessna Skyhawk airplane which petitioner purchased from Lansing in 1979. The other three checks were clearly marked on their face as being for the purchase of an airplane, or aerial navigation equipment. As to these three

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items, petitioner's testimony was extremely vague and contradictory and we have accepted these checks as payment for the purposes shown thereon.

With respect to the other checks detailed in our findings of fact, petitioner at trial either was unable to state with any certainty what the payments were for, when specifically asked about them on cross-examination, or failed to testify with respect to the items at all. We are thus unable to accept any of the payments, totaling $10,685.32, as detailed in our findings of fact, as constituting equity investments by petitioner in the stock of Lansing.

In addition to these payments, however, petitioner contends that he made a further equity investment in Lansing in the amount of the insurance recovery for the damage to the Cessna Skyhawk plane, in the amount of $8,809, which petitioner urges should be credited to him because he allowed Lansing to keep the insurance recovery money, while buying the plane and undertaking to restore it at his own expense. We find this argument entirely confusing and unconvincing. What the record shows is that petitioner bought an aircraft from Lansing. Prior to petitioner's purchase, the aircraft had been damaged. The regular retail price of the aircraft was about $35,000, and petitioner paid $26,500 for it in its then condition. Lansing, as seller|owner, got the insurance recovery to which it was entitled. The difference between petitioner's purchase price of $26,500 and the regular retail price of $35,000, or about $8,500, is very close to the amount of

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the insurance recovery, and clearly gives effect to the loss of value in the damaged plane. Under the circumstances, we can find no theory which would support petitioner's argument that somehow he made an equity investment in Lansing by allowing Lansing to keep the insurance recovery to which it was clearly entitled. Lansing got the insurance recovery, and petitioner got the benefit of the reduced price for the plane in an "as is" condition.

In sum, and after trying vainly to make some sense out of petitioner's rambling and sometimes inconsistent and incoherent testimony, we must conclude that petitioner has failed to prove either that he was the owner of any stock in Lansing, or, if he was, what his cost basis was in such stock. Having so concluded, it is unnecessary for us to consider the third prong of petitioner's necessary proof, as to the year of worthlessness of such stock.

Decision will be entered under Rule 155.

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T. C. Memo. 1986-360

UNITED STATES TAX COURT

RUSSELL L. AND BONNIE C. SHORT, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 23526-83. Filed August 7, 1986.

Petitioners owned 50 percent of the stock of a corporation incorporated in 1977 that became worthless in November 1980.

Held: Petitioners stock in the corporation did not qualify as section 1244 stock.

Held, Further: Loans from petitioners to the corporation and claims for uncollected rental due petitioners from the corporation, which became worthless in 1980, were non-business bad debts.

Gerald A. Dechow and James W. Hopper, for the petitioners.

T. Keith Fogg, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

DRENNEN, Judge: Respondent determined deficiencies and additions to tax in petitioners' Federal income tax as follows:

Year	Deficiency	Additions to Tax Sec. 6651(a)(1)[1/]	Sec. 6651(a)(2)
1978	$17,832.99	$4,458.25	$378.56
1979	1,973.46	-0-	19.84
1980	40,668.03	-0-	-0-
1981	11,956.00	-0-	-0-

1/ All section references are to the Internal Revenue Code of 1954, as amended, and in effect during the taxable years at issue.

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After concessions by both parties,[2] the issues remaining for our decision are (1) whether the issuance of stock by Roanoke Truck Sales, Inc. (RTS), complied with section 1244 resulting in petitioners incurring ordinary losses when the stock became worthless in 1980; and (2) whether loans made by petitioners to RTS are deductible as business bad debts.

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[2] Petitioners have conceded by stipulation that they are liable for the additions to tax under sections 6651(a)(1) and (2) for the year 1978 and for the addition to tax under section 6651(a)(2) for the year 1979. However, in Estate of Young v. Commissioner, 81 T.C. 879 (1983), this Court held that it does not have jurisdiction to redetermine the addition to tax under section 6651(a)(2) for late payment because it is not attributable to a deficiency. Accordingly our decision in this case cannot redetermine the amount of the addition to tax under section 6651(a)(2) for either year.

Respondent concedes that petitioners are allowed deductions for depreciation of $8,418.47 and $6,980.79 in 1980 and 1981, respectively.

The parties agree that adjustment (a) of the notice of deficiency is revised as follows:

Year	Amount disallowed in notice of deficiency	Revised disallowance
1980	$38,966.37	$36,322.42
1981	27,248.16	8,267.20

The parties agree that a loss incurred by petitioners in 1981 on the sale of certain property is $16,337.39, rather than $73,523.59 claimed by petitioners on their return for 1981.

Petitioners concede that they received additional interest income in 1980 of $63.

Petitioners concede that $36,664.61 of materials and labor deducted in 1981 are not allowable.

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FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference. The pertinent facts are summarized below.

Petitioners Russell L. and Bonnie C. Short are individual taxpayers whose legal residence was Roanoke, Virginia at the time they filed their petition in this case. Petitioners separated on January 5, 1981, and were subsequently divorced.

Petitioners filed joint Federal income tax returns for the calendar years 1977, 1978, 1979, 1980 and 1981, with the Internal Revenue Service Center in Memphis, Tennessee. Petitioners' 1978 return was filed untimely on December 19, 1979, reflecting a total tax due of $26,322.95. Petitioners had withholding tax credits for 1978 of $4,169.16. The 1978 return was filed with no remittance.

Petitioners' 1979 return reflected a total tax due of $9,719.45. Petitioners had withholding tax credits of $5,010.20. This return was filed untimely on June 19, 1980, with no remittance.

RTS filed its articles of incorporation on December 29, 1976. Its certificate of incorporation was issued January 6, 1977. Petitioner Russell L. Short (Russell), and Hal J. Cooper (Cooper), were listed as the initial directors of RTS' Board of

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Directors. Russell and Cooper both signed the articles of incorporation. The corporate purpose for the formation of RTS was described as follows:

> To sell, lease, purchase, demonstrate, repair and deal in new and used motor vehicles of all kinds, as well as engines, chassis, bodies, tires and all parts, accessories and supplies of motor vehicles; and to conduct any other business not prohibited by law not required to be stated in the Articles of Incorporation.

RTS' articles of incorporation refer to the adoption of a section 1244 plan as follows:

> To the extent permitted by law all common stock of the corporation shall qualify as "Section 1244 Stock" within the meaning of section 1244 of the Internal Revenue Code of 1950, as amended and Treasury regulations promulgated thereunder.

Harvey S. Lutkins acted as the attorney for RTS in preparing its corporate documents including the plan to distribute section 1244 stock. Petitioners' section 1244 plan as submitted into evidence is a preprinted form with blank spaces where one is to supply the dollar amount of the common stock to be issued, the date the plan was adopted, and the signature of the corporation's secretary. None of these blank spaces was filled in.

The corporate minutes and section 1244 document were not signed by Russell. Cooper signed the corporate minutes but not the section 1244 document.

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Prior to forming RTS, Russell and Cooper had an auto parts business that they conducted on a small scale. They then decided to move this business into a building owned by petitioners and formed RTS. Russell and Cooper were the sole stockholders of RTS.

Petitioner Bonnie C. Short (Bonnie), was employed by RTS as its president. Bonnie was a high school graduate and had also attended Brandon Secretarial and Accounting School in 1971. As president of RTS, she was in charge of "all the ordering, all the hiring, the clerical work, [and] the financial work." Bonnie at no time owned any stock or invested any money in RTS. She reported salaries from RTS in 1978, 1979, and 1980 as $9,495, $15,600, and $7,125, respectively. Prior to being employed as president of RTS, Bonnie worked as president of Short's Boat Sales which sold marine parts. Short's Boat Sales was incorporated and was owned by Russell. Russell at no time reported any income except rental income from RTS.3/

Petitioners' basis in RTS for purposes of computing a gain or loss is $16,200. Petitioners' stock in RTS became worthless in November of 1980.

3/ Petitioners also reported gross rental income during the years at issue as follows:

Tax Year	Income
1978	$64,067
1979	39,600
1980	39,600
1981	21,600

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Petitioners owned the land and building where RTS conducted its operations. From 1978 to 1980, RTS was charged rent by petitioners. RTS deducted the rent on its corporate tax returns and petitioners included the rent in their individual tax returns although none of the rent was ever actually received by petitioners. Petitioners reported gross rental income from RTS in 1978, 1979, and 1980 of $18,000, $21,600, and $21,600, respectively.4/

Russell received and reported compensation income from Russell Short, Inc. in the amounts of $23,400, $26,000, and $29,400 for the years 1978, 1979 and 1980, respectively.

In July 1979, petitioners loaned RTS $60,000 for working capital. They obtained the money through a personal loan from United Virginia Bank. Bonnie stated that at this time RTS was selling transfer trucks and needed additional working capital. Petitioners used the inventory of RTS, the building and its land, as collateral for the loan. RTS made several payments to petitioners on this loan; however, as of November 1980, RTS owed petitioners $43,500 on this debt.

In October 1980, petitioners obtained an additional loan from United Virginia Bank. Of this loan, $48,330 was used to satisfy a corporate debt of RTS which petitioners had personally guaranteed. Bonnie stated that this loan was obtained to "keep

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4/ Petitioners reported a net loss from rentals of various properties for each of those years.

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the business going." The inventory of RTS, the building and land, were again used as collateral. RTS made no payments to petitioners for these funds.

On November 20, 1980, RTS ceased doing business. At this time, Bonnie's employment as president of RTS also ceased. Bonnie drew unemployment from November 20, 1980, until sometime in January of 1981. On February 28, 1981, she began a new job working for Virginia Farm Bureau Insurance. Her income from this job amounted to $12,288 in 1981. Bonnie obtained the job in order to support herself. Petitioners had separated on January 5, 1981, and Russell was supporting their children.

OPINION

We must determine whether the initial offering of RTS stock complied with section 1244. Respondent contends that a section 1244 plan was not adopted by RTS as the plan was never signed by anyone in behalf of the corporation. Respondent further contends that whether or not RTS intended to adopt a section 1244 plan cannot be determined since neither Russell, nor Cooper, or RTS' attorney testified at the trial of this case. In the alternative respondent contends that even if the RTS stock was issued pursuant to a valid section 1244 plan, petitioners do not qualify for section 1244 treatment because some of their stock was issued for services.

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Petitioners contend that a section 1244 plan was adopted by RTS despite the fact that the plan was never formally signed by Russell or Cooper. Petitioners contend that they relied upon their attorney to prepare the necessary documents to adopt a section 1244 plan and therefore should not be penalized for not signing the documents since they believed that all the requirements to adopt a section 1244 plan had been completed. Petitioners conclude that the fact that they intended to adopt a section 1244 plan should control in determining whether such a plan was adopted.

For the reasons detailed below, we agree with respondent.

Section 1244 provides that, subject to certain conditions and limitations, a loss on the sale or exchange (including a transaction treated as a sale or exchange), of "section 1244 stock" which would otherwise be treated as a loss from the sale or exchange of a capital asset shall be treated as an ordinary loss. See sec. 1.1244(a)-1, Income Tax Regs.

"Section 1244 stock" is defined in section 1244(c)(1) as stock in a domestic corporation if

> (A) at the time such stock is issued, such corporation was a small business corporation,
>
> (B) such stock was issued by such corporation for money or other property (other than stock and securities), and
>
> (C) such corporation during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

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Section 1.1244(c)-1(f)(1)(i), Income Tax Regs.,[5] provides special rules applicable to the issuance of section 1244 stock prior to November of 1978,[6] as follows:

> Pre-November 1978 common stock must have been issued under a written plan adopted by the corporation after June 30, 1958, and on or before November 6, 1978 ***.

This regulation appears to embody the comments of the House Committee which provided that:

> The stock must have been issued pursuant to a plan to offer not more than a stated dollar amount of stock during a period *** specified in the plan. Such plan must be in writing and adopted after June 30, 1958. *** [H. Rept. 2198, 85th Cong., 1st Sess. (1958), 1959-2 C.B. 709, 714. Emphasis added].

Petitioners contend that they should be allowed section 1244 treatment for their RTS stock despite the fact that the RTS Board of Directors never signified formal adoption of such a plan by signing the required documents. We cannot agree. Petitioners have offered little evidence to prove that a section 1244 plan was ever formally adopted by Russell and Cooper. The "plan" submitted into evidence by petitioners is a preprinted form

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5/ The validity of section 1.1244(c)-1(f)(1)(i), Income Tax Regs. has been upheld by this Court on several occasions. Malinowski v. Commissioner, 71 T.C. 1120, 1126-1127 (1979); Kaplan v. Commissioner, 59 T.C. 178, 181 (1972); Spiegel v. Commissioner, 49 T.C. 527, 531 (1968).

6/ Although the record is unclear, respondent's arguments assume that the RTS stock was issued prior to November 1978. Petitioners do not object nor argue otherwise. Sec. 345(c), Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2845, eliminated the requirement in the regulations that sec. 1244 stock be issued pursuant to a written plan. However, such amendment applies only to stock issued after the date of the enactment of such Act (Nov. 6, 1978). See n. 2, Malinowski v. Commissioner, supra at 1127.

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apparently obtained by petitioners' attorney. This form has blank spaces where one is to supply the dollar amount of common stock to be issued, the date the plan was adopted, and the signature of the corporation's secretary. None of these blank spaces have been filled in. RTS' articles of incorporation do refer to section 1244 stock providing that

> to the extent permitted by law all common stock of the corporation shall qualify as "Section 1244 Stock" within the meaning of section 1244 of the Internal Revenue Code of 1950, as amended, and Treasury Regulations promulgated thereunder.7/

However, the minutes of the organizational meeting of RTS do not make reference to a section 1244 plan.8/After carefully reviewing the evidence presented, we do not view it as sufficient to support a finding that a section 1244 plan was ever adopted by RTS. The form submitted by petitioners was neither completed nor signed. Moreover, no testimony was presented by either Russell, or Cooper, or RTS' attorney concerning their intent to establish a section 1244 plan for RTS. We therefore find that a section 1244 plan was never adopted by RTS. Accordingly, respondent's determination that petitioners' stock in RTS did not qualify for

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7/ In their reply brief petitioners argue that the reference to sec. 1244 in the Articles of Incorporation taken with the Form Plan create a sec. 1244 plan. This Court held in Hoffman v. Commissioner, T.C. Memo. 1970-16 that the Certificate of Incorporation there involved did not constitute the requisite written plan. See also Hurd v. Commissioner, T.C. Memo. 1975-6.

8/ The corporate by-laws included with these minutes are also not signed by Russell.

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section 1244 treatment is sustained.[9] See Malinowski v. Commissioner, 71 T.C. 1120 (1979); Kaplan v. Commissioner, 59 T.C. 178 (1972); Speigel v. Commissioner; 49 T.C. 527 (1968); Morgan v. Commissioner, 46 T.C. 878 (1966).

We next must determine whether petitioners are entitled to a bad debt deduction under section 166(a), or section 166(d), for three obligations owed to them by RTS. The first obligation involves petitioners' claim of a business bad debt for rent not received from RTS but reported by petitioners as ordinary income. The second obligation is a loan of $60,000 made by petitioners to RTS in 1979 for working capital. RTS repaid $16,500 of this loan. The final obligation at issue involves the satisfaction by petitioners in October 1980 of an obligation owed by RTS to a third party of $48,330 which petitioners had guaranteed.

Petitioners contend that the obligations paid by them are deductible as business bad debts because petitioners paid the obligations with the expectation that RTS would eventually become a greater source of income to Bonnie.

Respondent contends that the obligations paid by petitioners did not give rise to business bad debts but were rather non-business bad debts.[10] Respondent contends that petitioners' true motive in making the loan and satisfying the obligations of

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[9] We do not address the issue of whether petitioners' basis in the RTS stock came from stock purchases that would qualify for section 1244 treatment due to the above holding.

[10] Respondent did not challenge petitioners' right to deduct the amounts as non-business bad debts.

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RTS was to preserve their investment in RTS.

We agree with respondent.

Section 166(a)(1) allows as a deduction any debt which becomes worthless within the taxable year. Business bad debts are deductible in the year they become worthless. Non-business bad debts are however treated as a short-term capital loss. Section 166(d)(1). Section 166(d)(2) defines a non-business bad debt as a debt other than -

> (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
>
> (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

A non-business bad debt is therefore a debt assumed, for example, to preserve one's investment as a shareholder as contrasted with an obligation to protect one's status as an employee, which is a business interest. United States v. Generes, 405 U.S. 93, 100 (1972).

To determine the character of the obligations at issue herein, we must determine petitioners' motivation at the time the obligations were incurred. Since we are concerned with individuals, the question is whether petitioners' "dominant motive" for making the loan and satisfying the obligations was to protect a business interest, not an investment.11/ Generes, supra at 104.

11/ The answer to this question is somewhat befuddled here because Bonnie received a salary but owned no stock while Russell owned one half of the stock but received no salary.

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Petitioners' motivation is a question of fact on which they bear the burden of proof. Smith v. Commissioner, 60 T.C. 316, 318 (1973). Some factors to be considered in making this determination are (1) the size of the taxpayer's investment; (2) the size of the taxpayer's after-tax salary; and (3) the other scurces of gross income available to the taxpayer. United States v. Generes, supra; Scifo v. Commissioner, 68 T.C. 714, 723 (1977); Shinefeld v. Commissioner, 65 T.C. 1092 (1976).

No evidence of the fair market value of petitioners' investment in RTS was presented but it would appear to be substantial. Russell was one of only two shareholders of RTS.

The salary earned by petitioners was not substantial in relation to their investment. Russell earned no salary from RTS. Bonnie earned $9,495 in 1978, $15,600 in 1979, and $7,125 in 1980, for a yearly average of $10,740. This amount is further lessened by the impact of taxes.

Moreover, petitioners had an additional source of gross income in that they earned rental income in 1978 of $64,067, in 1979 of $39,600, and in 1980 of $39,600.12/ Russell also received income from Russell Short, Inc. during 1978, 1979, and 1980 of $23,400, $26,000, and $29,400, respectively.

Bonnie testified that she and Russell obtained a loan of $60,000 in 1979 to provide RTS with additional working capital. She stated that "the business was doing pretty good, but the cash

12/ As previously noted, petitioners reported net rental losses after rather large deductions for depreciation.

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flow was getting short." She obtained an additional loan in October 1980 in order to "keep the business going." Bonnie expressed a desire to keep the business going because she wanted to work. She argues that she wanted to keep RTS going to protect her income source. However our analysis must focus on the objective facts presented and not be swayed by self-serving testimony. United States v. Generes, supra at 104.

Accordingly, in light of the fact that petitioners had a substantial investment in RTS, that Bonnie's salary was insubstantial compared to petitioners' other sources of income, and that petitioners had considerable other sources of gross income, we find that petitioners' dominant motivation was to protect their investment.13/ We are further persuaded by the fact that since Russell was one of the two shareholders, Bonnie had little fear of losing her job. Davenport v. Commissioner, 70 T.C. 922, 933 (1978).

Accordingly, petitioners are not entitled to a business bad debt deduction. Respondent's determination on this issue is therefore sustained.

Decision will be entered under Rule 155.

13/ Cf. Hutchinson v. Commissioner, T.C. Memo. 1982-45.

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T. C. Memo. 1986-361

UNITED STATES TAX COURT

POWERS AND PAMELA BOOTHE, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 33208-84. Filed August 7, 1986.

R selected P for audit based upon P's relationship to a partnership audit. During mid-April R's agent, in an effort to cause P to extend the statute of limitations on assessment, visited P's business manager who was not authorized to execute a waiver to extend the statutory period, but who advised R's agent that P was out of the country until mid-July. R mailed a statutory notice to P's then current address, with an incorrect zip code.

Held: P's address out of the country was temporary and, without P's request designating it, the foreign address does not become P's "last known address" within the meaning of sec. 6212(b), I.R.C. 1954.

Held further: Failure to affix a correct zip code to a taxpayer's address upon the envelope in which a statutory notice of deficiency is mailed does not invalidate the notice.

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Glenn Guritzky and Robert E. Linkin, for the petitioners.

Frances Ferrito Regan, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge: Respondent determined deficiencies in Federal income tax for petitioners' taxable years 1977 and 1980 in the amounts of $3,610 and $40,999, respectively. This proceeding arises from cross-motions to dismiss for lack of jurisdiction. Respondent's motion is based upon the contention that the petition was untimely. Petitioners' motion is based upon the contention that respondent did not send a statutory notice to petitioners' "last known address."[1]

FINDINGS OF FACT

The proposed deficiencies in this case arise from one adjustment concerning petitioners' interest in a partnership. Respondent was auditing the partnership and no separate audit of petitioners' return was being conducted or had been begun by respondent. Essentially, respondent was "controlling" petitioners' 1980 taxable year[2] during the pendency of the partnership audit. Shortly before the 3-year statute of

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1 If we find for petitioners, respondent may not be able to assess or collect the proposed deficiencies due to the expiration of the 3-year statute of limitations. If we find for respondent, the deficiencies may be assessed and collected, and petitioners will have the option of contesting the merits of the proposed deficiencies in a refund forum.

2 The 1977 taxable year is involved only to the extent that the 1980 loss reported through the partnership generated a net operating loss deduction which could be carried back to 1977.

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limitations on assessment and collection was to expire (April 15, 1984), respondent's agents in New York attempted to make contact with petitioners to solicit agreements to extend the period within which to assess.

Petitioners are husband and wife and they filed a joint Federal individual income tax return for the taxable year 1980. Petitioner-husband is a professional actor and on occasion is away from home for filming on location. During the period beginning February 27, 1984, and concluding in mid-July 1984, both petitioners were in Brazil for on-location filming concerning petitioner-husband. While away from home, petitioner-husband's business manager handled his day-to-day business and personal financial affairs. The business manager was provided with petitioners' mailing address, telephone number and the length of their stay while in Brazil. Petitioners tried to limit the type of mail delivered to their residence to that from personal friends and family.

Respondent's agents in New York, in their attempt to effectuate an extention of the 3-year limitations period, located petitioner-husband's business manager in New York, because his company name appeared along with petitioners' on respondent's copy of the Form K-1[3] from the partnership. Respondent's agents contacted petitioner-husband's business manager on a date

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[3] The Form K-1 is used by partnerships to advise partners of the pass-through items for income tax purposes. Respondent usually receives copies of the Forms K-1 along with the return of the partnership.

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approaching April 15, 1984, and were advised that petitioners were in Brazil. Further, the business manager was without a power of attorney and unable to agree to extend the statutory period for assessment and collection. The record in this case is unclear as to whether respondent's agents were advised of petitioners' Brazilian mailing address.

Due to the time limitations, respondent decided to issue a statutory notice to stay the expiration of the statutory period. The mailing address reflected on petitioners' 1980 return was in California, but was not petitioners' address as of April 14, 1984. Respondent, by means of a search of his records, discovered a second California address, which happened to be petitioners' address on April 14, 1984. Based upon the available information, on April 14, 1984, respondent mailed by certified mail three duplicate original statutory notices of deficiency for the 1977 and 1980 taxable years. One notice was sent to the address shown on petitioners' 1980 return and was returned to respondent with the Postal Service notation that "Authorized Time For Forwarding Has [Expir]ed." The second notice was mailed to petitioner-husband's business manager in New York, but the address was incorrect;[4] and the Postal Service returned it to respondent with the notation, "Attempted, Not Known New York, N.Y. 10022." The third original notice was sent to petitioners'

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[4] For purposes of this case, respondent admits that the attempted mailing of a notice of deficiency to petitioners in care of his business manager was of no effect.

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then current and correct permanent address, with the exception that the zip code utilized by respondent was incorrect. It appears that respondent used petitioners' prior zip code in mailing the notice to petitioners' correct and current residence on April 14, 1984. The Postal Service returned the "third notice" with the notation that it was "Unclaimed." Upon return from Brazil, petitioner-husband discovered a slip from the Postal Service indicating attempted delivery of certified or registered mail. The Postal Service advised that the mail represented by the slip(s) had been returned to sender. Accordingly, petitioners were not aware that respondent was the "sender."

After receiving a tax bill from respondent, petitioners, while residing in California, mailed a petition to this Court by means of an envelope bearing a September 12, 1984, private post meter stamp, which was received and filed on September 17, 1984. Ostensibly, the petition was mailed 151 days, and actually received by the Court 156 days, after respondent mailed the statutory notices of deficiency on April 14, 1984.

OPINION

Petitioners' motion to dismiss involves section 6212[5] which authorizes respondent to send a notice of deficiency to a "taxpayer at his last known address." Although petitioner has couched the wording of the issue to focus upon respondent's

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5 All statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the period under consideration.

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obligation to determine the "last known address," the more refined issues for our consideration are: (1) Whether the temporary or non-permanent change in the mailing address of petitioners became their "last known address" for purposes of section 6212(b)(1); and (2) whether an incorrect zip code with an otherwise correct mailing address will render a notice of deficiency ineffective or invalid within the framework of section 6212(a) and (b)(1).

The parties do not dispute the fact that the petition was untimely, whether measured by the 90 or 150-day period of section 6213(a). Accordingly, if we determine that any of the three notices mailed April 14, 1984, are within the requirements of section 6212, respondent's motion to dismiss for lack of jurisdiction, due to an untimely petition, should be granted.

The Temporary or Non-Permanent
Address As the "Last Known Address"

A taxpayer's last known address is the last known permanent address or legal residence of the taxpayer, or the last known temporary address of a definite duration or period to which all communications during such period should be sent. Gregory v. United States, 102 Ct.Cl. 642, 663, 57 F. Supp. 962, 973 (1944); McCormick v. Commissioner, 55 T.C. 138, 141 (1970); Weinroth v. Commissioner, 74 T.C. 430, 435 (1980). The Commissioner must exercise reasonable diligence in determining a taxpayer's correct address and the burden is on the taxpayer to provide the

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Commissioner with clear and concise notification of a new address. Alta Sierra Vista, Inc. v. Commissioner, 62 T.C. 367, 374 (1974), affd. without opinion 538 F.2d 334 (9th Cir. 1976). In the absence of clear and concise notification by the taxpayer, the Commissioner may use the address appearing on the taxpayer's return. Luhring v. Glotzbach, 304 F.2d 556, 558-559 (4th Cir. 1962); Lifter v. Commissioner, 59 T.C. 818, 821 (1973).

Petitioners contend that respondent did not exercise reasonable diligence because he failed to send a notice to Brazil and/or to petitioner-husband's business manager's correct address. Respondent contends that petitioners' most recent California address was their "last known address" because petitioners' stay in Brazil was too temporary to become the "last known address" within the meaning of section 6212. With respect to the business manager's address, respondent contends that it was not clearly and concisely communicated by the taxpayers or their agent as a change of address or a place to which correspondence concerning their tax matters should be sent. We agree with respondent on this issue.

Petitioners have argued that respondent was provided with a Brazilian mailing address by petitioner-husband's business manager and that respondent's agent was also advised of the exact dates they would be in Brazil. Respondent counters that his agent(s) was aware that petitioners were in Brazil but that respondent was not advised of the Brazilian mailing address or

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the exact dates petitioners were to be in Brazil. Respondent admits that his agent was aware that petitioners were temporarily in Brazil on business.

The outcome of this proceeding does not hinge upon respondent's knowledge of the exact dates or address because petitioners' stay in Brazil was too brief to reasonably alert respondent to consider it a change of "last known address." Cohen v. United States, 297 F.2d 760, 773 (9th Cir. 1962); Gregory v. United States, 102 Ct.Cl. at 663. Neither petitioners nor their authorized agent clearly and concisely communicated or directed respondent to send communications to Brazil. Alta Sierra Vista, Inc. v. Commissioner, supra at 374; Weinroth v. Commissioner, supra at 435; Gregory v. United States, supra.

Factually, this case is a classic example of a situation where the taxpayers' "last known address" was reflected on their return(s) and they are temporarily residing at another location. To find otherwise in this setting may promote anomalous results. If respondent were able to satisfy the requirements of section 6212 by mailing a statutory notice of deficiency to a temporary residence, where the taxpayer has not so directed, it is likely that this forum would not be available to numerous taxpayers who are similarily situated. E.g., see Estate of Reger v. Commissioner, T.C. Memo. 1983-669, where respondent was not permitted to rely upon what he perceived to be the taxpayer's "last known address." Similarly, the setting here was one where

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respondent sought out petitioner-husband's business manager in an attempt to extend the statute of limitations on assessment and collection. Petitioner-husband's business manager was not authorized to represent petitioners for Federal tax purposes and was without any power of attorney. Bailey v. Commissioner, T.C. Memo. 1982-274. Although petitioner-husband's manager advised that petitioners were in Brazil for approximately three more months, respondent's agents were not requested to change petitioners' address to which tax correspondence was to be sent. Even if we were to assume the existence of a power of attorney in the business manager, no directions or request to send tax correspondence to petitioners in Brazil or to himself was made by the business manager. See Houghton v. Commissioner, 48 T.C. 656, 661 (1967).

Petitioners argue that respondent had a duty or responsibility to determine that they were in Brazil and that Brazil was their "last known address," citing Frieling v. Commissioner, 81 T.C. 42, 49 (1983), and Keeton v. Commissioner, 74 T.C. 377, 382 (1980). In Frieling, the taxpayers specifically notified respondent of a new mailing address by means of a direct oral communication and then placed their new address on a Form 872, which was forwarded to respondent. Under those facts we held that there had been adequate notice of a change of address and respondent should have exercised reasonable care to ascertain and mail the notice to the correct address. In Keeton, we held

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that respondent should have known and used the taxpayer's new address because he was incarcerated in connection with his violation of Federal income tax laws. Both of the cases advanced by petitioners herein involved a situation where respondent was aware of a new permanent address or the taxpayer had directed a change in correspondence address. Once respondent becomes aware of an address other than the one on a taxpayer's return, respondent must exercise reasonable care and whether he has done so is a question of fact. McPartlin v. Commissioner, 653 F.2d 1185, 1189 (7th Cir. 1981), revg. an unpublished order of this Court; Weinroth v. Commissioner, supra. In the instant case, petitioners did not direct a change and the change was merely temporary.

Moreover, we cannot agree with petitioners that respondent's knowledge of petitioner-husband's business manager's address should have caused respondent to recognize that address as petitioners' "last known address" without clear and concise directions or communication to respondent to use that address. The business manager's lack of authority to execute an extention of the limitations period and the absence of a power of attorney would dictate that a business manager's address appearing on a Form K-1 should not become a taxpayer's "last known address" without deference to the address shown on the tax return. It is not unlikely that a single taxpayer may have several Forms K-1

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associated with their taxable year and each may contain a different address.

Accordingly, we hold that respondent's knowledge that petitioners were temporarily in Brazil and of the existence of a business manager was not sufficient to change petitioners' "last known address" as shown on their return(s). Respondent exercised reasonable care and diligence in attempting to mail a statutory notice to the address reflected on petitioners' return.[6]

The Effect of
Incorrect Zip Code Upon the
Validity of a Statutory Notice

Having determined that petitioners' "last known address" was not that of the business manager or did not change to their temporary mailing address in Brazil, we now consider whether respondent complied with the statute regarding any of the three notices mailed on April 14, 1984. Respondent diligently sought out petitioners' newer California address and therefore was obligated to use the newer address. Keeton v. Commissioner, supra at 832. Although petitioners' names, street number and name, city and state were all correct, the zip code was for petitioners' former California address. Petitioners did not establish that the U.S. Postal Service failed to comply with

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6 A recent line of cases in the 9th Circuit has held respondent to a high standard of researching the correct address of a taxpayer in the available institutional information. Respondent has met that standard by seeking a later year's address from his records. For example, see Wallin v. Commissioner, 744 F.2d 674 (9th Cir. 1984).

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postal regulations or that a zip code is an element essential to delivery of the notice in question. Failure of petitioners to actually receive the notice does not vitiate it. Lifter v. Commissioner, 59 T.C. 818 (1973).

We have held that inconsequential errors in addressing a notice of deficiency do not destroy its validity. Clodfelter v. Commissioner, 57 T.C. 102, 107 (1971), affd. 527 F.2d 754, 756 (9th Cir. 1975); Estate of McElroy v. Commissioner, 82 T.C. 509, 514 (1984). In a Memorandum Opinion of this Court we noted that "the USPS [Postal Service] does not require a zip code on a piece of mail as a prerequisite to the delivery of the mail." Kochanowski v. Commissioner, T.C. Memo. 1983-72 [45 TCM 666, 52 P-H Memo T.C. par. 83,072]. Further, the notice sent to petitioners' correct address (but with the wrong zip code) was returned by the Postal Service as "Unclaimed", not as undeliverable. As noted above, the fact that petitioners did not actually receive the notice does not vitiate its effectiveness. See also Davis v. Commissioner, T.C. Memo. 1980-176, affd. without published opinion 649 F.2d 862 (4th Cir. 1981), where we held a notice valid with a misspelled street name and erroneous zip code. The failure of delivery in Davis was due to the Postal Service's 1-year limit on the forwarding of mail. In view of the foregoing, we find that respondent had sent a statutory notice of deficiency to petitioners' "last known address" within the 3-year period and petitioners have failed to file a timely petition.

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Accordingly, respondent's motion to dismiss for lack of jurisdiction will be granted and petitioners' motion to dismiss for lack of jurisdiction will be denied.

An appropriate order will be entered.

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